

MARCHEX INC  
Form 424B4  
February 10, 2005

Filed Pursuant to Rule 424(b)(4)  
Registration No. 333-121213 and 333-122651

## 200,000 Shares

## MARCHEX, INC.

### 4.75% Convertible Exchangeable Preferred Stock

#### (Cumulative Dividend, Liquidation Preference of \$250 per share)

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- Marchex, Inc. is offering 200,000 shares of 4.75% convertible exchangeable preferred stock, par value \$0.01 per share.
- Dividends will be cumulative from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.
- The preferred stock is convertible at the option of the holder at any time, unless previously redeemed or exchanged, into our Class B common stock, par value \$0.01 per share, at an initial conversion price of \$24.50 (equivalent to a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock). The initial conversion price is subject to adjustment in certain events.
- At any time, we may elect to automatically convert some or all of the preferred stock into shares of our Class B common stock if the closing price of our Class B common stock has exceeded \$36.75, subject to adjustment, which is 150% of the conversion price for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.
- If we elect to automatically convert some or all of the preferred stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any
- Prior to February 20, 2008, the preferred stock is not redeemable at our option. Thereafter, the preferred stock is redeemable at our option, in whole or in part, at the declining redemption prices set forth herein, together with accrued dividends to, but excluding the redemption date.
- The preferred stock is exchangeable, in whole but not in part, at our option on any dividend payment date beginning February 15, 2006, for our 4.75% convertible subordinated debentures at the rate of \$250 principal amount of debentures for each share of preferred stock. The debentures, if issued upon exchange of the preferred stock, will mature on the twenty-five year anniversary of the exchange date. The debentures, if issued, will have terms substantially similar to those of the preferred stock.
- The preferred stock has no maturity date and voting rights prior to conversion into Class B common stock, except under limited circumstances.
- Shares of our Class B common stock are listed on the Nasdaq National Market under the symbol MCHX. The last reported sale price of our Class B common stock on February 8, 2005 was \$22.30 per share. Our preferred stock has been approved for listing on the Nasdaq National Market under the symbol MCHXP.
- Simultaneously with this offering of preferred stock, Marchex is offering 8,000,000 shares of Class B common stock, excluding up to 1,200,000 shares available to cover over-allotments, by means of a separate prospectus.

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dividends already paid on the preferred stock.

- The closing of this offering is subject to the concurrent closing of the Name Development asset acquisition described in this prospectus and the closing of the concurrent Class B common stock offering.

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This investment involves risks. See Risk Factors beginning on page 14.

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	<u>Per Share</u>	<u>Total</u>
Public offering price	\$ 250.00	\$ 50,000,000
Underwriting discount	\$ 8.75	\$ 1,750,000
Proceeds, before expenses, to Marchex, Inc.	\$ 241.25	\$ 48,250,000

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The offering prices set forth above do not include accrued dividends, if any. Dividends on the preferred stock will accrue from the date of original issuance of the preferred stock, expected to be February 14, 2005.

*The underwriters have a 30-day option to purchase up to 30,000 additional shares of preferred stock from us to cover over-allotments, if any.*

Neither the Securities and Exchange Commission nor any state securities commission has approved of anyone's investment in these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

**Piper Jaffray**

**RBC Capital Markets**

**Thomas Weisel Partners LLC**

The date of this prospectus is February 8, 2005.

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You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. This prospectus is not an offer to sell, nor is it seeking an offer to buy, these securities in any state where the offer or sale is not permitted. The information in this prospectus is complete and accurate as of the date on the front cover, but the information may have changed since that date.

Unless otherwise specified or the context otherwise requires, references in this prospectus to *we*, *our* and *us* refer to Marchex, Inc. and its wholly-owned subsidiaries, including Enhance Interactive, Inc. (formerly ah-ha.com, Inc.), TrafficLeader, Inc. (formerly Sitewise Marketing, Inc.) and goClick.com, Inc., on a consolidated basis.

## PROSPECTUS SUMMARY

*The items in the following summary are described in more detail later in this prospectus. This summary provides an overview of selected information about us, the offerings and the proposed Name Development asset acquisition contained elsewhere in this prospectus and does not contain all the information you should consider. Therefore, you should also read the more detailed information set out in this prospectus, the financial statements and the other information incorporated by reference into this prospectus.*

### Overview

We provide technology-based merchant services that facilitate and drive growth in online transactions. We connect merchants with consumers who are searching for information, products and services on the Internet. Our platform of integrated performance-based advertising and search marketing services enables merchants to more efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and other selected Web properties.

Upon the completion of the Name Development asset acquisition, we believe we will be among the leaders in the direct navigation market. We will own a proprietary base of online user traffic that represented more than 17 million unique visitors in November 2004, searching for information, products and services. This user traffic is generated from a portfolio of Web properties, or Internet domains, which are generally reflective of commercially-relevant search terms in many of the Internet's most popular and dynamic vertical commerce categories, and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000. Key vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, professional services, home and garden, Web and telecom services, education, and entertainment. The online user traffic is primarily monetized with pay-per-click listings that are relevant to the Web properties. As such, the Web properties connect online users searching for specific information with relevant advertisements.

With the Name Development asset acquisition, we believe we will be one of the few companies that owns both proprietary search engine marketing services and a critical mass of proprietary online user traffic.

Merchants transacting online is a large and growing trend. Our services facilitate and support the efficient and cost-effective marketing and selling of goods and services online through the most rapidly-developing forms of search-based marketing methods. We accomplish this by providing multiple services:

- ***Pay-Per-Click Services.*** We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories and other Web properties.
- ***Feed Management Services.*** We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers' databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. These feed management listings are ordered in the results based on relevance to user search queries. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web's largest search engines, product shopping engines and directories.
- ***Advertising Campaign Management Services.*** We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.
- ***Search Engine Optimization Services.*** We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.
- ***Outsourced Search Marketing Services Platform.*** We provide large aggregators of advertisers, such as yellow page companies, with an outsourced, integrated platform to enable them to market performance-based advertising and search marketing services directly to their customers.

We distribute performance-based advertisements through our broad network of distribution partners comprising many of the leading search engines, product shopping engines, directories and other Web properties. Our sources of distribution include industry leaders such as Yahoo!, Google, Shopping.com and many others.

## **Pending Name Development Asset Acquisition**

### ***Description of the Asset Acquisition***

On November 19, 2004, we entered into an agreement to acquire certain assets of Name Development, a corporation operating in the direct navigation market. Direct navigation is one of the methods that consumers use to search for information, products or services online. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources. Name Development owns and maintains a portfolio of Internet domains, or Web properties, that are generally reflective of online user search terms, descriptive keywords and keyword strings. Name Development has entered into agreements with advertising service providers to monetize its online user traffic with pay-per-click listings. As such, Name Development is able to connect online users searching for specific information with relevant advertisements.



Upon completion of the asset acquisition, we believe we will be among the leaders in the direct navigation market due to our proprietary ownership of online user traffic, which totaled more than 17 million unique visitors in November 2004. This user traffic is generated from a portfolio of Web properties, which are generally reflective of commercially-relevant search terms in many of the Internet's most popular vertical commerce categories, and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000. Key vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, professional services, home and garden, Web and telecom services, education and entertainment.

Name Development's revenue increased 260% from \$3.5 million for the fiscal year ended June 30, 2003 to \$12.5 million for the fiscal year ended June 30, 2004. For the corresponding periods, income from operations grew from \$3.2 million to \$12.6 million. For the nine months ended September 30, 2004, revenues were \$15.5 million and income from operations was \$14.9 million.

We expect to account for the Name Development asset acquisition as a business combination. The closing of the transaction is conditioned on a number of factors, including the successful completion of these offerings to finance the purchase by us. For more information on the asset acquisition, see Name Development Asset Acquisition.

#### *Anticipated Benefits of the Asset Acquisition*

We believe that the Name Development asset acquisition will provide us with several benefits, including:

- ***A Defensible, Proprietary Source of Targeted Traffic.*** We believe that we will have an exclusive position due to the nature of Internet domain registration, which is similar to owning real-estate in that each Internet domain name is unique. The asset acquisition will provide us with Web properties that collectively generated more than 17 million unique visitors in November 2004. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000.
- ***Synergies with our Existing Search Engine Marketing Services Platform.*** We believe that our technology platform, combined with the acquired assets, gives us an advantage in extending market share within the direct navigation market and expanding our participation in the search advertising market and in key commerce verticals.
- ***Platform to Extend Expansion Initiatives.*** We intend to use the asset acquisition to supplement our planned expansion, both domestically and internationally.

#### *Transaction Structure*

The aggregate consideration to be paid under the asset purchase agreement is an amount of cash equal to \$155.2 million and the number of shares of our Class B common stock obtained by dividing \$9.0 million by the average of the last quoted sale price for shares of our Class B common stock on the Nasdaq National Market for the ten trading days immediately prior to the closing.

The asset purchase agreement contains customary representations and warranties and requires Name Development's sole stockholder to indemnify us for various liabilities arising under the agreement, subject to various limitations and conditions. At the closing of the asset acquisition, we will deposit into escrow, for a period of eighteen months from the closing date, an amount of cash equal to \$24.6 million to

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secure the sole stockholder's indemnification and other obligations under the asset purchase agreement.



The asset acquisition is contingent on customary closing conditions, including the closing by us of financing sufficient to consummate such acquisition. If the closing does not occur on or before June 30, 2005, we may be required to pay Name Development a termination fee of \$1.5 million through a combination of cash and equity. We have also agreed to file a registration statement to register the shares of Class B common stock issued as equity consideration in the transaction or any shares of Class B common stock issued in connection with payment of the termination fee for resale on Form S-3 once we become eligible to file such a registration statement with the SEC.

## **Industry Overview**

### *Performance-Based Advertising*

As technology and the Internet continue to evolve, consumers are becoming increasingly confident that they can find comprehensive product information and securely transact online. As consumers spend more time and money online, advertisers are turning to the Internet to market their products and services. Businesses of all sizes can benefit from the Internet's potential to efficiently and cost-effectively reach consumers. Internet advertising enables merchant advertisers to measure the effectiveness of their advertising campaigns and to revise them in response to real-time feedback and market factors. Within the Internet advertising market, paid search has become one of the fastest growing sectors. Merchant advertisers are increasingly turning to performance-based online advertising due to its competitive return-on-investment and consumers increasing receptiveness to this medium.

### *Direct Navigation*

Currently, there are three primary means through which online users access and search for information, products and services: search engines and directories, commerce portals and direct navigation Web properties. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources.

First Albany Capital estimates that the paid search market will reach \$4.5 billion in revenue in 2004, and we believe the direct navigation market currently represents more than 10% of the global search market and is growing at comparable annual rates. According to WebSideStory, Inc.'s StatMarket division, in September 2004 more than 67% of daily global Internet users arrived at Web sites by direct navigation defined as typing a URL into a browser address bar or using a bookmark rather than through search engines and Web links, compared to approximately 53% in February 2002. The growth of the direct navigation market is a result of consumers' increasing sophistication in utilizing the Internet as a resource tool, coupled with their desire to quickly find targeted information, and their trust and experience that the depth and breadth of available and relevant online information extends to Web sites named by descriptive keywords. Direct navigation and the use of search engines, however, are not mutually exclusive. We believe that many of the commercially relevant Web properties which we will own as part of the Name Development asset acquisition may be beneficiaries of search engine traffic.

## **Strategy**

We intend to leverage our senior management's experience, our financial and human resources, and our existing operations to provide technology-based merchant services that facilitate and drive growth in online transactions. Key elements of our strategy include the following initiatives:

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- Provide quality services in support of merchants and partners;
- Increase the number of merchants served;
- Develop new markets;

- Extend presence in the direct navigation market; and
- Pursue selective acquisition and consolidation opportunities.

### **Acquisitions**

Acquisition initiatives have played an important part in our corporate history, since our incorporation on January 17, 2003, and are a component of our strategy. Including the proposed Name Development asset acquisition, we will have made four acquisitions since our inception.

- On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive.
- On October 24, 2003, we acquired TrafficLeader.
- On July 27, 2004, we acquired goClick.
- In conjunction with this offering, we will acquire certain assets of Name Development.

### **Our Relationship with Our Founding Executive Officers**

As of December 31, 2004, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, beneficially owned 54% of our outstanding capital stock, which represented 93% of the combined voting power of our outstanding capital stock. Upon completion of the Class B common stock and preferred stock offerings, these founding executive officers will beneficially own 40% of all of our outstanding capital stock, excluding the shares of Class B common stock issuable upon conversion of the preferred stock being offered in the preferred stock offering, which will represent 90% of the combined voting power of our outstanding capital stock.

### **Recent Developments**

#### ***Fourth Quarter Financial Results***

On February 3, 2005, we announced our unaudited operating results for the quarter ended December 31, 2004. Revenue for the fourth quarter of 2004 was \$15.1 million, compared to \$7.5 million for the fourth quarter of 2003. Net income for the fourth quarter of 2004 was \$607,000, compared to a net loss applicable to common stockholders of \$1.1 million for the fourth quarter of 2003.

Operating income before amortization (OIBA) for the fourth quarter of 2004, which excludes from net income (a) stock-based compensation of \$169,000, (b) amortization of intangible assets of \$1.5 million, (c) other income, net of \$100,000, and (d) tax expense of \$152,000, was \$2.3 million. For the comparable period of 2003, OIBA, which excludes from net loss (a) stock-based compensation of \$538,000, (b) amortization of

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intangible assets of \$994,000, (c) other income, net of \$41,000, and (d) tax benefit of \$301,000, was \$448,000.

The results for the quarter ended December 31, 2004 are preliminary and subject to change as we complete our closing procedures and as our independent auditors complete the audit of our financial statements for fiscal year 2004.

For a discussion of management's reasons for disclosing OIBA in addition to net income as calculated in accordance with accounting principles generally accepted in the U.S., see Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Operating Income Before Amortization on page 58 of this prospectus.

***Strategic Alliance with Overture***

On February 3, 2005 we also announced that in connection with the closing of the Name Development asset acquisition and in furtherance of our overall strategic alliance with Overture Services, Inc. ( Overture ), we intend to enter into (i) a new master agreement with Overture with respect to our direct navigation business, and (ii) a license agreement with Overture with respect to certain of Overture s patents, including but not limited to U.S. Patent No. 6,269,361, pursuant to which we will pay \$4,500,000 in an upfront payment (and an additional \$674,000 in certain circumstances) and a royalty based on certain percentages of certain of our gross revenues payable on a quarterly basis through December 2016, which royalty amount is currently estimated to be between \$1,000,000 and \$3,000,000 in the aggregate for 2005.

***Legal Proceedings***

On February 3, 2005, we received notice of a purported class action complaint entitled Pagniello v. Cool Web Search, Enhance Interactive, Inc., Marchex, Inc., FindWhat.com Inc., Google Inc., Yahoo/Overture Search Engine Co., Microsmarts, LLC, STOPzilla, Inc., PC Tools Pty Ltd., eBlocs.com, and Network Dynamics Corporation, which was filed in the United States District Court for the Northern District of Georgia on January 24, 2005. The complaint alleges that the defendants have exploited web browsers and reconfigured his and others computers by installing code on their computers without their approval or knowledge and seeks injunctive relief and damages. Based on our initial review of the complaint, we believe that we have meritorious defenses to these claims and intend to contest them vigorously. However, since the litigation is in a preliminary stage and any litigation is inherently uncertain, it is not feasible at this time to predict how this matter will proceed, what the ultimate outcome will be or whether an unfavorable outcome could have a material adverse impact on our business.

***Concurrent Offerings***

Simultaneously with this offering of preferred stock, Marchex is offering 8,000,000 shares of Class B common stock, excluding up to 1,200,000 shares available to cover over-allotments by means of a separate prospectus. The closing of this offering is subject to the concurrent closing of the Name Development asset acquisition described in this prospectus and the closing of the concurrent Class B common stock offering.

***Office Location***

Our principal executive offices are located at 413 Pine Street, Suite 500, Seattle, Washington 98101, and our telephone number is (206) 331-3300. We maintain a number of Web sites, including our corporate Web site at [www.marchex.com](http://www.marchex.com). The information on our Web sites is not incorporated by reference into and does not form a part of this prospectus.

## The Offering

Securities Offered by Marchex, Inc.	200,000 shares of 4.75% convertible exchangeable preferred stock, par value \$0.01 per share, plus an additional 30,000 shares of preferred stock if the underwriters exercise their over-allotment option in full.
Dividends	Dividends will be cumulative from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.
Conversion Rights	Unless we redeem or exchange the preferred stock, the preferred stock can be converted at your option at any time into shares of Class B common stock, par value \$0.01 per share, at an initial conversion price of \$24.50 (equivalent to a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock). The initial conversion price with respect to the preferred stock is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change, which are explained in more detail under the section entitled "Description of Preferred Stock Conversion Rights Conversion Price Adjustment Merger, Consolidation or Sale of Assets."
Automatic Conversion	We may elect to automatically convert some or all of the preferred stock if the closing price of our Class B common stock has exceeded 150% of the conversion price for at least 20 out of 30 consecutive trading days ending within five trading days prior to the notice of automatic conversion.
Dividend Make-Whole Payment	If we elect to automatically convert some or all of the preferred stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable by us in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of our Class B common stock.
Liquidation Preference	\$250 per share of preferred stock, plus accrued and unpaid dividends.
Optional Redemption	On or after February 20, 2008, we may redeem the preferred stock, in whole or in part, at our option at the redemption prices set forth in this prospectus, together with accrued dividends to, but excluding, the redemption date. See the section entitled "Description of Preferred Stock Optional Redemption" below.

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Voting Rights	Except as provided by law and in other limited situations described in this prospectus, you will not be entitled to any voting rights. However, you will, among other things, be entitled to vote as a separate class to elect two directors if we have not paid the equivalent of six or more quarterly dividends, whether or not consecutive. These voting rights will continue until we pay the full accrued but unpaid dividends on the preferred stock.
Exchange Provisions	At our option, we may exchange the preferred stock in whole, but not in part, on any dividend payment date beginning on February 15, 2006 for our 4.75% convertible subordinated debentures. If we elect to exchange the preferred stock for debentures, the exchange rate will be \$250 principal amount of debentures for each share of preferred stock. The debentures, if issued upon exchange of the preferred stock, will mature 25 years after the exchange date.
Debentures	The debentures, if issued upon exchange of the preferred stock, will have the following terms:
Interest Rate	The debentures will have an interest rate of 4.75% per year. Interest will be payable on February 15 and August 15 of each year, beginning on the first interest payment date after the exchange date.
Redemption	On or after February 20, 2008 we may redeem the debentures at the redemption prices listed in this prospectus, plus accrued interest.
Maturity	The debentures will mature 25 years after the exchange date.
Conversion	The debentures may be converted at any time prior to maturity into Class B common stock at the same conversion price applicable to the preferred stock.
Automatic Conversion	We may automatically convert the debentures at any time prior to maturity under the same terms applicable to the preferred stock.
Interest Make-Whole Payment	If we elect to automatically convert some or all of the debentures prior to February 15, 2008, we will make an additional payment on the debentures equal to the value of the aggregate amount of interest that would have accrued and become payable on the debentures from the date of issuance upon the exchange through and including February 15, 2008, less any interest already paid on the debentures. This additional payment is payable by us in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of our Class B common stock.
Subordination	The debentures are subordinated to all existing and future senior indebtedness and are effectively subordinated to all of the indebtedness and other liabilities, including trade and other payables, of our subsidiaries. As of September 30, 2004, we had

approximately \$6.8 million of indebtedness and other liabilities outstanding to which the debentures would have been effectively subordinated, including trade and other payables, but excluding intercompany liabilities. The indenture governing the debentures does not limit the amount of indebtedness, including senior indebtedness, that we and our subsidiaries may incur. See the section entitled "Description of the Debentures Subordination" below.

Concurrent Offering

In a separate, concurrent offering, we are offering 8,000,000 shares of our Class B common stock, excluding a maximum of 1,200,000 shares which may be issued upon exercise in full of the underwriter's over-allotment option. The Class B common stock offering is being made exclusively by a separate prospectus.

Use of Proceeds

We intend to use the net proceeds from this offering, together with the net proceeds from the preferred stock offering, to pay for the pending Name Development asset acquisition and for working capital and other general corporate purposes, including potential future acquisitions. See "Use of Proceeds."

Nasdaq National Market Symbol for the Preferred Stock

MCHXP

Nasdaq National Market Symbol for the Class B MCHX Common Stock

Risk Factors

You should carefully read and consider the information set forth under the caption "Risk Factors" and all other information set forth in this prospectus before investing in Marchex's preferred stock.



### Summary Consolidated Financial Data

The following tables summarize historical and pro forma consolidated financial data regarding our business and should be read together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our historical and pro forma consolidated financial statements and the related notes included elsewhere in this prospectus. The summary information presented for the period from January 17, 2003 (inception) to September 30, 2003, the period from January 17, 2003 (inception) to December 31, 2003, and the nine months ended September 30, 2004 has been derived from our consolidated financial statements included elsewhere in this prospectus. The results of operations of Enhance Interactive are also derived from financial statements included elsewhere in this prospectus and have been presented as the Predecessor for the year ended December 31, 2002 and for the period from January 1, 2003 to February 28, 2003. See subsection Presentation of Financial Reporting Periods on page 46 for a further description of the basis of presentation of the 2003 period and of other financial reporting periods.

The unaudited pro forma condensed consolidated statement of operations data for the year ended December 31, 2003 give effect to: (1) our 2003 acquisitions of Enhance Interactive and TrafficLeader and our 2004 acquisition of goClick; and (2) our proposed Name Development asset acquisition and the offerings, as if they had all occurred on January 1, 2003. The unaudited pro forma condensed consolidated statements of operations for the year ended December 31, 2003 are based upon the historical results of operations of Marchex for the period from January 17, 2003 (inception) through December 31, 2003, the Predecessor for the period from January 1, 2003 through February 28, 2003, TrafficLeader for the period from January 1, 2003 through October 23, 2003 and goClick and Name Development for the year ended December 31, 2003. The unaudited pro forma condensed consolidated statement of operations data for the nine months ended September 30, 2004 give effect to: (1) our 2004 acquisition of goClick; and (2) our proposed Name Development asset acquisition and the offerings, as if they had all occurred on January 1, 2003. The unaudited pro forma condensed consolidated statement of operations for the nine months ended September 30, 2004 are based upon the historical results of operations of Marchex for the nine months ended September 30, 2004, goClick for the period from January 1, 2004 through July 26, 2004 and for Name Development for the nine months ended September 30, 2004.

The summary unaudited pro forma condensed consolidated statement of operations data are presented for illustrative purposes only and do not represent what our results of operations actually would have been if the transactions referred to above had occurred as of the dates indicated or what our results of operations will be for future periods.

In addition, the completion of the Class B common stock offering is not contingent upon the completion of the preferred stock offering.

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	Predecessor Periods		Successor Periods				
	Year ended December 31, 2002	Period from January 1 to February 28, 2003	Marchex Period from January 17, (inception) to December 31, 2003	Pro Forma Marchex, Prior and Pending Acquisitions and Offering 2003	Marchex Period from January 17, (inception) to September 30, 2003	Nine months ended September 30, 2004	
					Marchex 2004	Pro Forma Marchex, Prior and Pending Acquisitions and Offering 2004	
<b>Consolidated Statement of Operations Data:</b>							
Revenue	\$ 10,070,507	\$ 3,071,055	\$ 19,892,158	\$ 34,993,516	\$ 12,431,493	\$ 28,682,924	\$ 47,890,567
Expenses:							
Service costs	6,334,173	1,732,813	11,292,070	19,431,873	6,806,021	18,142,886	21,186,372
Sales and marketing	1,821,237	365,043	2,460,683	3,341,578	1,592,722	3,196,996	3,217,449
Product development	811,673	144,479	1,291,422	1,613,807	844,399	1,636,321	1,733,063
General and administrative	976,881	234,667	2,743,919	3,476,947	1,816,522	2,613,932	3,439,835
Acquisition-related retention consideration			283,269	283,269		374,858	374,858
Facility relocation						199,960	199,960
Stock-based compensation	364,693	38,981	2,125,110	2,659,280	1,587,476	721,403	721,403
Amortization of intangible assets			3,023,408	20,774,974	2,028,244	3,473,976	14,460,401
Total operating expenses	10,308,657	2,515,983	23,219,881	51,581,728	14,675,384	30,360,332	45,333,341
Gain on sale of intangible assets, net				965,297			1,507,498
Income (loss) from operations	(238,150)	555,072	(3,327,723)	(15,622,915)	(2,243,891)	(1,677,408)	4,064,724
Other income (expense)	5,491	1,529	74,059	70,148	33,502	218,974	226,878
Income (loss) before provision for income taxes	(232,659)	556,601	(3,253,664)	(15,552,767)	(2,210,389)	(1,458,434)	4,291,602
Income tax expense (benefit)	(142,876)	224,082	(1,084,312)	(5,609,792)	(783,231)	(118,016)	2,076,639
Net income (loss)	(89,783)	332,519	(2,169,352)	(9,942,975)	(1,427,158)	(1,340,418)	2,214,963
Accrual of convertible preferred stock dividends				2,375,000			1,781,250
Accretion of redemption value of redeemable convertible preferred stock			1,318,885	1,318,885	911,620	420,430	420,430
Net income (loss) applicable to common stockholders	\$ (89,783)	\$ 332,519	\$ (3,488,237)	\$ (13,636,860)	\$ (2,338,778)	\$ (1,760,848)	\$ 13,283
<b>Consolidated Statement of Cash Flows Data:</b>							
Cash flows from operating activities	\$ 1,539,808	\$ 353,053	\$ 2,907,053		\$ 1,738,073	\$ 2,335,785	
<b>Other Financial Data:</b>							
Operating income before amortization (OIBA) <sup>(1)</sup>	\$ 126,543	\$ 594,053	\$ 1,820,795	\$ 7,811,339	\$ 1,371,829	\$ 2,517,971	\$ 19,246,528

Footnote on page 13.

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The following table sets forth our consolidated balance sheet data as of September 30, 2004 on:

- an actual basis;
- a pro forma basis to give effect to: (1) the sale of 8,000,000 shares of Class B common stock at the public offering price of \$20.00 per share, less \$8.7 million in estimated underwriting discounts and estimated offering expenses; and (2) the sale of 200,000 shares of preferred stock at the price of \$250 per share, less \$2.0 million in estimated underwriting discounts and estimated offering expenses; and
- a pro forma as adjusted basis to also give effect to the Name Development asset acquisition.

	As of September 30, 2004		
	Actual	Pro forma	Pro forma, as adjusted
<b>Consolidated Balance Sheet Data:</b>			
Cash and cash equivalents	\$ 24,772,316	\$ 224,122,316	\$ 68,972,316
Total current assets	28,008,769	227,358,769	72,324,723
Total assets	62,504,069	261,854,069	271,324,069
Total current liabilities	7,270,020	7,270,020	7,740,020
Total stockholders' equity	54,463,628	253,813,628	262,813,628

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The following table provides a reconciliation of Income (loss) from operations and Net income (loss) applicable to common stockholders to the non-GAAP measure of OIBA.

	Predecessor Periods		Successor Periods				
	Year ended December 31, 2002	Period from January 1 to February 28, 2003	Period from January 17, (inception) to December 31, 2003	Pro Forma Marchex Prior and Pending Acquisitions and Offering 2003	Pro Forma Marchex Marchex Period from January 17, (inception) to September 30, 2003	Nine months ended September 30	
					Marchex	Prior and Pending Acquisitions and Offering	
					2004	2004	
Operating income before amortization (OIBA) <sup>(1)</sup>	\$ 126,543	\$ 594,053	\$ 1,820,795	\$ 7,811,339	\$ 1,371,829	\$ 2,517,971	\$ 19,246,528
Stock-based compensation	(364,693)	(38,981)	(2,125,110)	(2,659,280)	(1,587,476)	(721,403)	(721,403)
Amortization of intangible assets			(3,023,408)	(20,774,974)	(2,028,244)	(3,473,976)	(14,460,401)
Income (loss) from operations	(238,150)	555,072	(3,327,723)	(15,622,915)	(2,243,891)	(1,677,408)	4,064,724
Other income (expense)							
Interest income	5,491	1,529	45,874	53,989	33,502	163,808	169,304
Interest expense						(3,728)	(3,728)
Adjustment to fair value of redemption obligation			25,500	25,500		55,250	55,250
Other			2,685	(9,341)		3,644	6,052
Total other income	5,491	1,529	74,059	70,148	33,502	218,974	226,878
Income (loss) before provision for income taxes	(232,659)	556,601	(3,253,664)	(15,552,767)	(2,210,389)	(1,458,434)	4,291,602
Income tax expense (benefit)	(142,876)	224,082	(1,084,312)	(5,609,792)	(783,231)	(118,016)	2,076,639
Net income (loss)	(89,783)	332,519	(2,169,352)	(9,942,975)	(1,427,158)	(1,340,418)	2,214,963
Accrual of convertible stock dividends				2,375,000			1,781,250
Accretion to redemption value of redeemable convertible preferred stock			1,318,885	1,318,885	911,620	420,430	420,430
Net income (loss) applicable to common stockholders	\$ (89,783)	\$ 332,519	\$ (3,488,237)	\$ (13,636,860)	\$ (2,338,778)	\$ (1,760,848)	\$ 13,283

<sup>(1)</sup> We report operating income before amortization (OIBA) that is a supplemental measure to GAAP. OIBA represents income (loss) from operations before: (1) stock-based compensation expense; and (2) amortization of intangible assets. This measure, among other things, is one of the primary metrics by which we evaluate the performance of our business. Additionally, management uses adjusted OIBA which excludes acquisition-related retention consideration as we view this as part of the earn-out consideration from the Enhance Interactive transaction. Adjusted OIBA is the basis on which our internal budgets are based and by which management is currently evaluated. Management believes that investors should have access to, and we are obligated to provide, the same set of tools that we use in analyzing our results. This non-GAAP measure should be considered in addition to results prepared in accordance with GAAP, and should not be considered in isolation, as a substitute for, or superior to, GAAP results. We believe this measure is useful to investors because it represents our consolidated operating results, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash expenses. OIBA has certain limitations in that it does not take into account the impact to our statement of operations of certain expenses, including non-cash stock-based compensation associated with our employees and acquisition-related accounting. We endeavor to compensate for the limitations of the non-GAAP

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measure presented by providing the comparable GAAP measure with equal or greater prominence, GAAP financial statements and detailed descriptions of the reconciling items and adjustments, including quantifying such items, to derive the non-GAAP measure.

## RISK FACTORS

*Any investment in our securities involves a high degree of risk. You should carefully consider the following information about these risks, together with the other information contained in this prospectus, before you decide whether to purchase our securities. Additional risks and uncertainties not currently known to us or that we currently do not deem material may also become important factors that may harm our business. If any of the following risks occur, our business, financial condition and results of operations could be materially adversely affected. In any such case, the trading price of our preferred stock could decline.*

### **Risks Relating to Our Company**

#### **Our limited operating history makes evaluation of our business difficult.**

We were formally incorporated in January 2003. We acquired Enhance Interactive in February 2003, TrafficLeader in October 2003 and goClick in July 2004 and in November 2004 entered into an agreement to acquire certain assets of Name Development.

We have limited historical financial data upon which to base planned operating expenses or forecast accurately our future operating results. Further, our limited operating history will make it difficult for investors and securities analysts to evaluate our business and prospects. Our failure to address these risks and difficulties successfully could seriously harm us.

#### **We have incurred net losses since our inception, and we expect our net losses to continue for the foreseeable future, which will adversely affect our ability to achieve profitability.**

We have incurred net losses since inception and had an accumulated deficit of \$5.2 million as of September 30, 2004. Our net losses are likely to continue for the foreseeable future. Also, our net losses may increase to the extent we increase our sales and marketing activities and acquire additional businesses. These efforts may prove to be more expensive than we currently anticipate which could further increase our net losses. We cannot predict if we will become profitable in the future. Even if we were to achieve profitability, we may not be able to sustain it.

#### **We are dependent on certain distribution partners, including Yahoo! and its subsidiaries, for distribution of our services, and we derive a significant portion of our total revenue through these distribution partners. A loss of distribution partners or a decrease in revenue from certain distribution partners could adversely affect our business.**

A relatively small number of distribution partners currently deliver a significant percentage of traffic to our merchant listings. Yahoo!, primarily through its subsidiaries, such as Inktomi and Overture, is our largest distribution partner, collectively representing approximately 19% of our total revenue for the nine months ended September 30, 2004 and was responsible for 100% of the revenue of Name Development during the same period. For the year ended December 31, 2003, distribution through Yahoo! and its subsidiaries collectively represented less than 10% of Marchex's total revenue.

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Our existing agreements with many of our larger distribution partners permit either company to terminate without penalty on short notice and are primarily structured on a variable-payment basis, under which we make payments based on a specified percentage of revenue or based on the number of paid click-throughs. We intend to continue devoting resources in support of our larger distribution partners, but there are no guarantees that these relationships will remain in place over the short- or long-term. In addition, we cannot be assured that any of these distribution partners will continue to generate current levels of revenue for us. A loss of any of these distribution partners or a decrease in revenue from any one of these distribution relationships could have an adverse effect on our revenue, and the loss of any one large distribution partner could have a material adverse effect on our business, financial condition and results of operations.

Companies distributing advertising on the Internet have experienced, and will likely continue to experience, consolidation. This consolidation has reduced the number of partners that control the online advertising outlets

with the most user traffic. According to comScore Media Metrix qSearch, Yahoo! Search accounted for 27% of the online searches in the United States in May 2004 and Google accounted for 37%. As a result, the larger distribution partners have greater control over determining the market terms of distribution, including placement of merchant advertisements and cost of placement. In addition, many participants in the performance-based advertising and search marketing industries control significant portions of the traffic that they deliver to advertisers. We do not believe, for example, that Yahoo! and Google are as reliant as we are on a third-party distribution network to deliver their services. This gives these companies a significant advantage over us in delivering their services, and with a lesser degree of risk.

**If we do not maintain and grow a critical mass of merchant advertisers and distribution partners, the value of our services could be adversely affected.**

Our success depends, in part, on the maintenance and growth of a critical mass of merchant advertisers and distribution partners and a continued interest in our performance-based advertising and search marketing services. If our business is unable to achieve a growing base of merchant advertisers, our current distribution partners may be discouraged from continuing to work with us, and this may create obstacles for us to enter into agreements with new distribution partners. Similarly, if our distribution network does not grow and does not continue to improve over time, current and prospective merchant advertisers may reduce or terminate their business with us. Any decline in the number of merchant advertisers and distribution partners could adversely affect the value of our services.

**We are dependent upon the quality of traffic in our network to provide value to our merchant advertisers, and any failure in our quality control could have a material adverse effect on the value of our services to our merchant advertisers.**

We monitor the quality of the traffic that we deliver to our merchant advertisers. We review factors such as non-human processes, including robots, spiders, scripts or other software, mechanical automation of clicking and other sources and causes of low-quality traffic. Even with such monitoring in place, there is a risk that a certain amount of low-quality traffic or traffic that is deemed to be less valuable by our merchant advertisers will be provided to our merchant advertisers, which, if not contained, may be detrimental to those relationships. Low-quality traffic may prevent us from growing our base of merchant advertisers and cause us to lose relationships with existing merchant advertisers.

**We may be subject to intellectual property claims, which could adversely affect our financial condition and ability to use certain critical technologies, divert our resources and management attention from our business operations and create uncertainty about ownership of technology essential to our business.**

Our success depends, in part, on our ability to protect our intellectual property and to operate without infringing on the intellectual property rights of others in the process. There can be no guarantee that any of our intellectual property will be adequately safeguarded, or that it will not be challenged by third parties. We may be subject to patent infringement claims or other intellectual property infringement claims, including claims of trademark infringement in connection with an acquisition of previously-owned Internet domain names, that would be costly to defend and could limit our ability to use certain critical technologies.

For example, Overture Services, a subsidiary of Yahoo! which operates in certain competitive areas with us, owns U.S. Patent No. 6,269,361, which purports to give Overture rights to certain bid-for-placement products and pay-per-performance search technologies. Overture is currently involved in litigation with FindWhat.com relating to this patent. FindWhat.com is vigorously contesting Overture's patent. If we were to acquire or develop a related product or business model that Overture construes as infringing the Overture patent or if Overture construes any of our current products or business models as infringing upon the Overture patent, then we could be asked to license, re-engineer our products and services or revise our business model according to terms that may be extremely expensive and/or unreasonable. As part of our overall business relationship with Yahoo!, we have entered into various agreements to license technologies and services from Yahoo! and its subsidiaries, and expect to continue discussions with these partners to license other technologies and services, which may include the Overture patent.





Any patent or other intellectual property litigation could negatively impact our business by diverting resources and management attention from other aspects of the business and adding uncertainty as to the ownership of technology, services and property that we view as proprietary and essential to our business. In addition, a successful claim of patent infringement against us and our failure or inability to license the infringed or similar technology on reasonable terms, or at all, could have a material adverse effect on our business.

**Following the offerings, we may need additional funding to meet our obligations and to pursue our business strategy. Additional funding may not be available to us and our financial condition could therefore be adversely affected.**

We have allocated a substantial portion of the net proceeds of the offerings to the proposed Name Development asset acquisition. Following the offerings, we may require additional funding to meet our ongoing obligations and to pursue our business strategy, which may include the selective acquisition of businesses and technologies. In addition, we have incurred and we may incur certain obligations in the future, including:

- We may be obligated to make performance payments based on 2004 earnings to the original shareholders and certain employees of eFamily and its wholly-owned subsidiary, Enhance Interactive, which we acquired in February 2003, with a maximum remaining aggregate payment obligation of \$10.0 million. For the 2004 calendar year, the total Enhance Interactive earnings-based payment obligation was approximately \$6.2 million.
- We may also be obligated to make revenue-based performance payments based on 2004 results to the original shareholders of TrafficLeader, which we acquired in October 2003, with a maximum aggregate payment obligation of \$1.0 million. For the 2004 calendar year, no payment was due under this provision.
- Upon the issuance of preferred stock as contemplated in the preferred stock offering, we will become obligated to pay dividends to the holders of such stock.
- If debentures are issued upon exchange of the preferred stock, we will become obligated to make interest payments to the holders of the debentures.

Following the offerings, there can be no assurance that additional financing arrangements will be available in amounts or on terms acceptable to us, if at all. Furthermore, the sale of additional equity or convertible securities will result in further dilution to existing stockholders. If adequate additional funds are not available, we will be required to delay, reduce the scope of, or eliminate material parts of the implementation of our business strategy, including potential additional acquisitions or internally-developed businesses.

**Our acquisitions could divert management's attention, cause ownership dilution to our stockholders, cause our earnings to decrease and be difficult to integrate.**

Our business strategy includes identifying, structuring, completing and integrating acquisitions. Acquisitions in the technology and Internet sectors involve a high degree of risk. We may also be unable to find a sufficient number of attractive opportunities to meet our objectives which include revenue growth, profitability and competitive market share. Our acquired companies may have histories of net losses and may expect net losses for the foreseeable future.

Acquisitions are accompanied by a number of risks that could harm our business, operating results and financial condition:

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- We could experience a substantial strain on our resources, including time and money, and we may not be successful;
- Our management's attention could be diverted from our ongoing business concerns;
- While integrating new companies, we may lose key executives or other employees of these companies;

- We may issue shares of our Class B common stock as consideration for acquisitions which may result in ownership dilution to our stockholders;
- We could fail to successfully integrate our financial and management controls, technology, reporting systems and procedures, or adequately expand, train and manage our workforce;
- We could experience customer dissatisfaction or performance problems with an acquired company or technology;
- We could become subject to unknown or underestimated liabilities of an acquired entity or incur unexpected expenses or losses from such acquisitions; and
- We could incur possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business.

Consequently, we might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated revenue and cost benefits.

**The loss of our senior management, including our founding executive officers, could harm our current and future operations and prospects.**

We are heavily dependent upon the continued services of Russell C. Horowitz, our chairman and chief executive officer, and John Keister, our president and chief operating officer, and the other members of our senior management team. Each member of our senior management team is an at-will employee and may voluntarily terminate his employment with us at any time with minimal notice. Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, each own shares of fully vested Class A common stock. Following any termination of employment, each of these employees would only be subject to a twelve-month non-competition and non-solicitation obligation with respect to our clients and customers under our standard confidentiality agreement.

Further, as of December 31, 2004, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister together controlled 93% of the combined voting power of our outstanding capital stock. Upon completion of the offerings, these founding executive officers together will control 90% of the combined voting power of all of our outstanding capital stock, excluding the shares of Class B common stock issuable upon conversion of preferred stock. Their collective voting control is not tied to their continued employment with Marchex. The loss of the services of any member of our senior management, including our founding executive officers, for any reason, or any conflict among our founding executive officers, could harm our current and future operations and prospects.

**We may have difficulty attracting and retaining qualified, experienced, highly skilled personnel, which could adversely affect the implementation of our business plan.**

In order to fully implement our business plan, we will need to attract and retain additional qualified personnel. Thus, our success will in significant part depend upon the efforts of personnel not yet identified and upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing personnel. We are also dependent on managerial and technical personnel to the extent they may have knowledge or information about our businesses and technical systems that may not be known by our other personnel. There can be no assurance that we will be able to attract and retain necessary personnel. The failure to hire and retain such personnel could adversely affect the implementation of our business plan.

**If we are unable to obtain and maintain adequate insurance, our financial condition could be adversely affected in the event of uninsured or inadequately insured loss or damage. Our ability to effectively recruit and retain qualified officers and directors may also be adversely affected if we experience difficulty in maintaining adequate directors and officers liability insurance.**

We may not be able to obtain and maintain insurance policies on terms affordable to us that would adequately insure our business and property against damage, loss or claims by third parties. To the extent our business or

property suffers any damages, losses or claims by third parties that are not covered or adequately covered by insurance, our financial condition may be materially adversely affected.

We currently have directors' and officers' liability insurance, but we may be unable to maintain sufficient insurance as a public company to cover liability claims made against our officers and directors. If we are unable to adequately insure our officers and directors, we may not be able to retain or recruit qualified officers and directors to manage our company, which could have a material adverse effect on our operations.

**New rules, including those contained in and issued under the Sarbanes-Oxley Act of 2002, may make it difficult for us to retain or attract qualified officers and directors, which could adversely affect our business and our ability to maintain the listing of our Class B common stock on the Nasdaq National Market.**

We may be unable to attract and retain qualified officers, directors and members of board committees required to provide for our effective management as a result of the recent and currently proposed changes in the rules and regulations which govern publicly-held companies, including, but not limited to, certifications from executive officers and requirements for financial experts on boards of directors. The perceived increased personal risk associated with these recent changes may deter qualified individuals from accepting these roles. The enactment of the Sarbanes-Oxley Act of 2002 has resulted in the issuance of a series of new rules and regulations and the strengthening of existing rules and regulations by the Securities and Exchange Commission, as well as the adoption of new and more stringent rules by the Nasdaq Stock Market.

Further, certain of these recent and proposed changes heighten the requirements for board or committee membership, particularly with respect to an individual's independence from the corporation and level of experience in finance and accounting matters. We may have difficulty attracting and retaining directors with the requisite qualifications. If we are unable to attract and retain qualified officers and directors, our business and our ability to maintain the listing of our shares of Class B common stock on the Nasdaq National Market could be adversely affected.

**If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud, which could harm our brand and operating results.**

Effective internal controls are necessary for us to provide reliable and accurate financial reports and effectively prevent fraud. We have devoted significant resources and time to comply with the new internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002. In addition, Section 404 under the Sarbanes-Oxley Act of 2002 requires that we assess and our auditors attest to the design and operating effectiveness of our controls over financial reporting. Our compliance with the annual internal control report requirement for our first fiscal year ending on or after July 15, 2005, the requisite SEC compliance date, will depend on the effectiveness of our financial reporting and data systems and controls across our operating subsidiaries. We expect these systems and controls to become increasingly complex to the extent that we integrate acquisitions and our business grows. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. We cannot be certain that these measures will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation or operation, could harm our operating results or cause us to fail to meet our financial reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock and our access to capital.

**Recently adopted changes in accounting rules and regulations, such as expensing of stock options and shares issued through the employee stock purchase plan, will result in unfavorable accounting charges and may require us to change our compensation policies.**

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Accounting methods and policies regarding expensing stock options are subject to review, interpretation and guidance from relevant accounting authorities, including the Financial Accounting Standards Board, or FASB.

For example, we currently are not required to record stock-based compensation charges if an employee's stock option exercise price equals or exceeds the fair value of our common stock at the date of grant. On December 16, 2004, the FASB adopted a revised final statement of financial accounting standards which requires us, as a small business issuer, to expense the fair value of stock options granted for periods beginning after December 15, 2005. In addition, under the FASB's final rules on employee stock purchase plans, we will incur an expense. We rely heavily on stock options to compensate existing employees and attract new employees. In light of these new requirements to expense stock options and shares issued under the employee stock purchase plan, we may choose to reduce our reliance on these as compensation tools. If we reduce our use of stock options and the employee stock purchase plan, it may be more difficult for us to attract and retain qualified employees and we may need to compensate our employees with greater amounts of cash or other incentives. If we do not reduce our reliance on stock options and the employee stock purchase plan, our reported losses will increase. Further changes to interpretations of accounting methods or policies in the future may require us to adversely revise how our financial statements are prepared.

**Impairment of goodwill and other intangible assets would result in a decrease in earnings.**

Current accounting rules require that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. These rules also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased.

We have substantial goodwill and other intangible assets, and we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. Any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

**Risks Relating to the Name Development Asset Acquisition**

**We may not be able to complete the transactions contemplated by this prospectus, which could negatively impact our reputation and prospects.**

The Name Development asset acquisition is dependent upon the successful completion of the simultaneous offerings of our Class B common stock and our preferred stock. We will be unable to finance the proposed asset acquisition without the funding from the net proceeds of these offerings. The closing of the proposed asset acquisition is also dependent on certain closing conditions, which if not met or not waived by Name Development or us, as the case might be, would release the parties from the terms of the asset purchase agreement. If we were unable to meet our obligations under the agreement, we would be obligated to pay a termination fee to Name Development of approximately \$1.5 million in a combination of cash and shares of our Class B common stock.

We have expended significant time, resources and manpower to pursue the asset acquisition and related financings, which could have been used for other purposes and opportunities. If the proposed asset acquisition and offerings are not consummated, we will have incurred significant expense which may affect our financial results. We will also have potentially foregone other transactions or devoted resources that could have been directed to our current operations during that period.



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Acquisitions are a component of our strategy. Our successful execution of this strategy relies in part on our reputation for delivering value for our target partners and our ability to demonstrate a successful transaction record. A failure to complete this transaction would, at this juncture in our corporate history, negatively impact our reputation and could adversely affect our prospects for future acquisitions or the terms on which we may complete such acquisitions.

**We may not be able to realize the intended and anticipated benefits from the Name Development asset acquisition, which could affect the value of the asset acquisition to our business strategy and our ability to meet our financial obligations and targets.**

We may not be able to realize the intended and anticipated benefits that we currently expect from the Name Development asset acquisition. These intended and anticipated benefits include increasing our cash flow from operations, growing our merchant network, broadening our distribution offerings and delivering services that strengthen our merchant relationships.

Factors that could affect our ability to achieve these benefits include:

- Name Development currently earns 100% of its revenue through the outsourcing of its pay-per-click listings to one major provider, Yahoo! In order to achieve the desired financial results from this asset acquisition, we will need to transition the existing commercial relationship on similar or better terms, develop other relationships for the delivery of pay-per-click listings or provide pay-per-click listings directly from our merchant advertisers, or some combination of the above. Our execution of this aspect of the acquired assets will be a significant factor in determining whether we realize the anticipated economic benefits.
- We will need to continue to acquire commercially valuable Internet domain names to grow our presence in the field of direct navigation. We will need to continuously improve our technologies to acquire valuable Internet domain names as competition in the marketplace for appropriate Internet domain names intensifies. Our domain name acquisition efforts are subject to rules and guidelines established by registries which maintain Internet domain name registrations and the registrars which process and facilitate Internet domain name registrations. The registries and registrars may change the rules and guidelines for acquiring Internet domains in ways that may prove detrimental to our domain acquisition efforts.
- The business of Name Development is dependent on current technologies and user practices. If browser or search technologies were to change significantly, the practice of direct navigation may be altered to our disadvantage.
- Some of our existing distribution partners may perceive Name Development as a competitive threat and therefore may decide to terminate their agreements with us because of the Name Development asset acquisition.
- We intend to apply our technology and expertise to geography-specific Web properties that we believe are under-commercialized and not yet mature from a monetization perspective. However, if the current disparities in traffic and monetization of such search terms do not narrow in a favorable way, we may expend significant company resources on business efforts that do not realize the results we expect.

If the acquired business is not integrated into our business as we anticipate, we may not be able to achieve these benefits or realize the value paid for the asset acquisition, which could materially harm our business, financial condition and results of operations.

**We may experience unforeseen liabilities in connection with the Name Development asset acquisition or our acquisition of other Internet domain names, which could negatively impact our financial results.**

The Name Development asset acquisition involves the acquisition of a large number of previously-owned Internet domain names. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names. In some cases, these acquired names may have trademark significance that is not readily apparent to us or is not identified by us in the bulk purchasing process. As a result we may face demands by third party trademark owners asserting infringement or dilution of their rights and seeking transfer of

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acquired Internet domain names under the Uniform Domain Name Dispute Resolution Policy administered by ICANN or actions under the U.S. Anti-Cybersquatting Consumer Protection Act.

We intend to review each claim or demand which may arise from time to time on its merits on a case-by-case basis with the assistance of counsel and we intend to transfer any rights acquired by us to any party that has demonstrated a valid prior right or claim. We cannot, however, guarantee that we will be able to resolve these disputes without litigation. The potential violation of third party intellectual property rights and potential causes of action under consumer protection laws may subject us to unforeseen liabilities including injunctions and judgments for money damages.

**Regulation could reduce the value of the Internet domain names acquired or negatively impact the Internet domain acquisition process, which could significantly impair the value of the asset acquisition.**

The Name Development business includes the registrations of thousands of Internet domain names both in the United States and internationally. Name Development acquires previously-owned Internet domain names that have expired and have been offered for sale by Internet domain name registrars following the period of permitted reclamation by their prior owners. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names.

The acquisition of Internet domain names generally is governed by regulatory bodies. The regulation of Internet domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional requirements for previously-owned Internet domain names or modify the requirements for holding Internet domain names. As a result, we might not acquire or maintain names that contribute to our financial results in the same manner as reflected in the historical financial results of Name Development. Because certain Internet domain names are important assets which support the valuation of the Name Development asset acquisition, a failure to acquire or maintain such Internet domain names could adversely affect our financial results and our growth. Any impairment in the value of these important assets could cause our stock price to decline.

#### **Risks Relating to Our Business and Our Industry**

**If we are unable to compete in the highly competitive performance-based advertising and search marketing industries, we may experience reduced demand for our products and services.**

We operate in a highly competitive and changing environment. We principally compete with other companies which offer services in five main areas:

- sales to merchant advertisers of pay-per-click services;
- sales to merchant advertisers of feed management services;
- aggregation or optimization of online advertising for distribution through search engines, product shopping engines, directories, Web sites or other outlets;
- delivery of online advertising to end users or customers of merchants through destination Web sites or other distribution outlets; and

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- services that allow merchants to manage their advertising campaigns across multiple networks and track the success of these campaigns.

Although we currently pursue a strategy that allows us to potentially partner with all relevant companies in the industry, there are certain companies in the industry that may not wish to partner with us. Despite the fact that we currently work with several of our potential competitors, there are no guarantees that these companies will continue to work with us in the future.

We currently or potentially compete with a variety of companies, including FindWhat.com, Google, Microsoft and Yahoo! Many of these actual or perceived competitors also currently or may in the future have business relationships with us, particularly in distribution. Going forward, however, these companies may terminate their relationships with us. Furthermore, our competitors may be able to secure agreements with us on more favorable

terms, which could reduce the usage of our services, increase the amount payable to our distribution partners, reduce total revenue and thereby have a material adverse effect on our business, operating results and financial condition.

We expect competition to intensify in the future because current and new competitors can enter our market with little difficulty. The barriers to entering our market are relatively low. In fact, many current Internet and media companies presently have the technical capabilities and advertiser bases to enter the search marketing services industry. Further, if the consolidation trend continues among the larger media and search engine companies with greater brand recognition, the share of the market remaining for smaller search marketing services providers could decrease, even though the number of smaller providers could continue to increase. These factors could adversely affect our competitive position in the search marketing services industry.

Some of our competitors, as well as potential entrants into our market, may be better positioned to succeed in this market. They may have:

- longer operating histories;
- more management experience;
- an employee base with more extensive experience;
- better geographic coverage;
- larger customer bases;
- greater brand recognition; and
- significantly greater financial, marketing and other resources.

Currently, and in the future, as the use of the Internet and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies and/or invest in or form joint ventures in categories or countries of interest to us, all of which could adversely impact our business. Any of these trends could increase competition and reduce the demand for any of our services.

**If we are not able to respond to the rapid technological change characteristic of our industry, our products and services may not be competitive.**

The market for our products and services is characterized by rapid change in business models and technological infrastructure, and we will need to constantly adapt to changing markets and technologies to provide competitive products and services. We believe that our future success will depend, in part, upon our ability to develop our products and services for both our target market and for applications in new markets. We may not, however, be able to successfully do so, and our competitors may develop innovations that render our products and services obsolete or uncompetitive.

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**Our technical systems are vulnerable to interruption and damage that may be costly and time-consuming to resolve and may harm our business and reputation.**

A disaster could interrupt our services for an indeterminate length of time and severely damage our business, prospects, financial condition and results of operations. Our systems and operations are vulnerable to damage or interruption from:

- fire;
- floods;
- network failure;
- hardware failure;
- software failure;
- power loss;

- telecommunications failures;
- break-ins;
- terrorism, war or sabotage;
- computer viruses;
- denial of service attacks;
- penetration of our network by unauthorized computer users and hackers and other similar events;
- natural disaster; and
- other unanticipated problems.

We may not have developed or implemented adequate protections or safeguards to overcome any of these events. We also may not have anticipated or addressed many of the potential events that could threaten or undermine our technology network. Any of these occurrences could cause material interruptions or delays in our business, result in the loss of data or render us unable to provide services to our customers. In addition, if a person is able to circumvent our security measures, he or she could destroy or misappropriate valuable information or disrupt our operations. We have deployed firewall hardware intended to thwart hacker attacks. Although we maintain property insurance and business interruption insurance, our insurance may not be adequate to compensate us for all losses that may occur as a result of a catastrophic system failure or other loss, and our insurers may not be able or may decline to do so for a variety of reasons.

If we fail to address these issues in a timely manner, we may lose the confidence of our merchant advertisers and distribution partners, our revenue may decline and our business could suffer. In addition, as we expand our service offerings and enter into new business areas, we may be required to significantly modify and expand our software and technology platform. If we fail to accomplish these tasks in a timely manner, our business and reputation will likely suffer.

**We rely on third party technology, server and hardware providers, and a failure of service by these providers could adversely affect our business and reputation.**

We rely upon third party colocation providers to host our main servers. If these providers experience any interruption in operations or cease operations for any reason or if we are unable to agree on satisfactory terms for continued hosting relationships, we would be forced to enter into a relationship with other service providers or assume hosting responsibilities ourselves. If we are forced to switch hosting facilities, we may not be successful in finding an alternative service provider on acceptable terms or in hosting the computer servers ourselves. We may also be limited in our remedies against these providers in the event of a failure of service. In the past, we have experienced short-term outages in the service maintained by one of our current colocation providers. We also rely on third party providers for components of our technology platform, such as hardware and software providers, credit card processors and domain name registrars. A failure or limitation of service or available capacity by any of these third party providers could adversely affect our business and reputation.



**We may not be able to protect our intellectual property rights, which could result in our competitors marketing competing products and services utilizing our intellectual property and could adversely affect our competitive position.**

Our success and ability to compete effectively are substantially dependent upon our internally developed and acquired technology and data resources, which we protect through a combination of copyright, trade secret, and patent and trademark law. To date, we have filed two provisional patent applications with the United States Patent and Trademark Office, and two non-provisional patent applications based on the two filed provisional applications in the United States and via the Patent Cooperation Treaty designating all member countries. In the future, additional patents may be filed with respect to internally developed or acquired technologies. Our industry is highly competitive and many individuals and companies have sought to patent processes in the industry. In

addition, the patent process takes several years and involves considerable expense. Further, patent applications and patent positions in our industry are highly uncertain and involve complex legal and factual questions due in part to the number of competing technologies. As a result, we may not be able to successfully prosecute these patents, in whole or in part, or any additional patent filings that we may make in the future. We also depend on our trade name and domain names. We may not be able to adequately protect our technology and data resources. In addition, intellectual property laws vary from country to country, and it may be more difficult to protect our intellectual property in some foreign jurisdictions in which we may plan to enter. If we fail to obtain and maintain patent or other intellectual property protection for our technology, our competitors could market competing products and services utilizing our technology. Any such failure could have a material adverse effect on our business.

Despite our efforts to protect our proprietary rights, unauthorized parties domestically and internationally may attempt to copy or otherwise obtain and use our services, technology and other intellectual property. We cannot be certain that the steps we have taken will prevent any misappropriation or confusion among consumers and merchant advertisers.

**We may be involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming.**

We may initiate patent litigation against third parties to protect or enforce our patent rights, and we may be similarly sued by others. We may also become subject to interference proceedings conducted in the patent and trademark offices of various countries to determine the priority of inventions. The defense and prosecution, if necessary, of intellectual property suits, interference proceedings and related legal and administrative proceedings is costly and may divert our technical and management personnel from their normal responsibilities. We may not prevail in any of these suits. An adverse determination of any litigation or defense proceedings could put our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not being issued.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could have an adverse effect on the trading price of our Class B common stock and the trading price of our preferred stock.

**We may incur liabilities for the activities of users of our services and our merchant advertisers, which could adversely affect our business.**

Many of our advertisement generation processes are automated and we do not conduct a manual editorial review of a substantial number of our merchant listings. We may not successfully avoid liability for unlawful activities carried out by users of our services and our merchant advertisers, or unpermitted uses of our merchant listings by distribution partners.

Our potential liability for unlawful activities of users of our services and our merchant advertisers or unpermitted uses of our merchant listings by distribution partners could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources or to discontinue certain service offerings. For example, as a result of the actions of merchant advertisers in our network, we may be subject to civil claims relating to a wide variety of issues, such as privacy, gambling, promotions, and intellectual property ownership and infringement. Furthermore, under agreements with certain of our larger distribution partners, we are required to indemnify these partners against any liabilities or losses resulting from the content of our merchant listings. Although our merchant advertisers indemnify us with respect to claims arising from these listings, we may not be able to recover all or any of the liability or losses incurred by us as a result of the activities of our merchant advertisers.



Our insurance policies may not provide coverage for liability arising out of activities of users of our services. Furthermore, we may not be able to obtain or maintain adequate insurance coverage to reduce or limit the liabilities associated with our businesses. Any costs incurred as a result of such liability or asserted liability could have a material adverse effect on our business, operating results and financial condition.

**Our quarterly results of operations might fluctuate due to seasonality, which could adversely affect our growth rate and in turn the market price of our securities.**

Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in the level of Internet usage. As is typical in our industry, the second and third quarters of the calendar year generally experience relatively lower usage than the first and fourth quarters. It is generally understood that during the spring and summer months of the year, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and in turn the market price of our securities.

**We are susceptible to general economic conditions, and a downturn in advertising and marketing spending by merchants could adversely affect our operating results.**

Our operating results will be subject to fluctuations based on general economic conditions, in particular those conditions that impact merchant-consumer transactions. If there were to be a general economic downturn that affected consumer activity in particular, however slight, then we would expect that business entities, including our merchant advertisers and potential merchant advertisers, could substantially and immediately reduce their advertising and marketing budgets. We believe that during periods of lower consumer activity, merchant spending on advertising and marketing is more likely to be reduced, and more quickly, than many other types of business expenses. These factors could cause a material adverse effect on our operating results.

**We depend on the growth of the Internet and Internet infrastructure for our future growth and any decrease or less than anticipated growth in Internet usage could adversely affect our business prospects.**

Our future revenue and profits, if any, depend upon the continued widespread use of the Internet as an effective commercial and business medium. Factors which could reduce the widespread use of the Internet include:

- possible disruptions or other damage to the Internet or telecommunications infrastructure;
- failure of the individual networking infrastructures of our merchant advertisers and distribution partners to alleviate potential overloading and delayed response times;
- a decision by merchant advertisers to spend more of their marketing dollars in offline areas;
- increased governmental regulation and taxation; and

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- actual or perceived lack of security or privacy protection.

In particular, concerns over the security of transactions conducted on the Internet and the privacy of users may inhibit the growth of the Internet and other online services, especially online commerce. In order for the online commerce market to develop successfully, we and other market participants must be able to transmit confidential information, including credit card information, securely over public networks. Any decrease or less than anticipated growth in Internet usage could have a material adverse effect on our business prospects.

**We are exposed to risks associated with credit card fraud and credit payment, and we may continue to suffer losses as a result of fraudulent data or payment failure by merchant advertisers.**

We have suffered losses and may continue to suffer losses as a result of payments made with fraudulent credit card data. Our failure to control fraudulent credit card transactions adequately could reduce our net revenue and gross margin. In addition, under limited circumstances, we extend credit to merchant advertisers who may default

on their accounts payable to us or fraudulently charge-back amounts on their credit cards for services that have already been delivered by us.

**Government regulation of the Internet may adversely affect our business and operating results.**

Companies engaging in online search, commerce and related businesses face uncertainty related to future government regulation of the Internet. Due to the rapid growth and widespread use of the Internet, legislatures at the federal and state levels have enacted and are considering various laws and regulations relating to the Internet. Individual states may also enact stricter consumer legislation that affects the conduct of our business.

Furthermore, the application of existing laws and regulations to Internet companies remains somewhat unclear. For example, as a result of the actions of merchant advertisers in our network, we may be subject to the application of existing laws and regulations relating to a wide variety of issues such as privacy, gambling, sweepstakes, promotions, financial market regulation, and intellectual property ownership and infringement. In addition, existing laws that regulate or require licenses or permits for certain businesses of merchant advertisers may be unclear in their application to our business, including those related to insurance and securities brokerage, law offices and pharmacies. Our business may be negatively affected by a variety of new or existing laws and regulations, which may expose us to substantial compliance costs and liabilities and may impede the growth in use of the Internet.

The application of these statutes and others to the Internet search industry is not entirely settled. Further, several existing and proposed federal laws could have an impact on our business. The existing federal laws include, among others:

- The Digital Millennium Copyright Act and its related safe harbors are intended to reduce the liability of online service providers for listing or linking to third-party Web sites that include materials that infringe copyrights or other rights of others.
- The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children, and they impose additional restrictions on the ability of online services to collect user information from minors.
- The Protection of Children from Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.
- The CAN-SPAM Act of 2003 and certain state laws are intended to impose limitations and penalties on the transmission of unsolicited commercial electronic mail via the Internet.
- The Electronic Communications Privacy Act is intended to protect the privacy of e-mail and other electronic communications.

Courts may apply each of these laws in unintended and unexpected ways. As a company that provides services over the Internet, we may be subject to an action brought under any of these or future laws governing online services. Among the types of legislation currently being considered at the federal and state levels are consumer laws regulating the practices for software applications or downloads and the use of cookies and these laws may introduce requirements for user consent and other restrictions. These proposed laws are intended to target applications often referred to as spyware, invasiveware or adware, although the scope may also include some software applications currently used in the online advertising industry to serve and distribute advertisements.

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Many of the services of the Internet are automated, and companies such as ours may be unknowing conduits for illegal or prohibited materials. It is not known how courts will rule in many circumstances; for example, it is possible that courts could find strict liability or impose know your customer standards of conduct in some circumstances. Although we may not be directly involved in any of these practices, under current and future regulation we may ultimately be held responsible for the actions of our merchant advertisers or distribution partners.

We may also be subject to costs and liabilities with respect to privacy issues. Several Internet companies have incurred costs and paid penalties for violating their privacy policies. Further, it is anticipated that new legislation will be adopted by federal and state governments with respect to user privacy. Such legislation could negatively affect our business.

Additionally, foreign governments may pass laws which could negatively impact our business and/or may prosecute us for our products and services based upon existing laws. Any such prosecution or costs incurred in addressing foreign laws could negatively affect our business.

The restrictions imposed by, and cost of complying with, current and possible future laws and regulations related to our business could harm our business and operating results.

**Future regulation of search engines may adversely affect the commercial utility of our search marketing services.**

The Federal Trade Commission, or FTC, has recently reviewed the way in which search engines disclose paid placements or paid inclusion practices to Internet users. In 2002, the FTC issued guidance recommending that all search engine companies ensure that all paid search results are clearly distinguished from non-paid results, that the use of paid inclusion is clearly and conspicuously explained and disclosed and that other disclosures are made to avoid misleading users about the possible effects of paid placement or paid inclusion listings on search results. Such disclosures if ultimately mandated by the FTC or voluntarily made by us may reduce the desirability of our paid placement and paid inclusion services. We believe that some users will conclude that paid search results are not subject to the same relevancy requirements as non-paid search results, and will view paid search results less favorably. If such FTC disclosure reduces the desirability of our paid placement and paid inclusion services, and click-throughs of our paid search results decrease, our business could be adversely affected.

**State and local governments may in the future be permitted to levy additional taxes on Internet access and electronic commerce transactions, which could result in a decrease in the level of usage of our services.**

On November 19, 2004, the federal government passed legislation placing a three-year ban on state and local governments' imposition of new taxes on Internet access or electronic commerce transactions. Unless the ban is extended, state and local governments may begin to levy additional taxes on Internet access and electronic commerce transactions upon the legislation's expiration in November 2007. An increase in taxes may make electronic commerce transactions less attractive for merchants and businesses, which could result in a decrease in the level of usage of our services.

**Risks Relating to this Offering**

**We may not be able to complete the proposed offering of our Class B common stock.**

We may not be able to complete the offering of 8,000,000 shares of our Class B common stock being conducted concurrently with this offering, or such offering may not raise the amount of proceeds we expect. If we are unable to complete the Class B common stock offering, we may not be able to execute fully on our contemplated acquisition strategy and the information in this prospectus regarding the Class B common stock offering would not be applicable or would need to be revised, perhaps significantly.



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**Our Class B common stock price has been and is likely to continue to be highly volatile. The price of our Class B common stock, and therefore the value of the preferred stock, may fluctuate significantly, which may make it difficult for holders to resell the preferred stock or the shares of our Class B common stock issuable upon conversion thereof when desired or at attractive prices.**

The trading price of our Class B common stock has been and is likely to continue to be highly volatile and subject to wide fluctuations. Since our initial public offering, the closing sale price of our Class B common stock on the Nasdaq National Market ranged from \$8.56 to \$21.00 per share through December 31, 2004, and the last

reported sale price on February 8, 2005 was \$22.30 per share. Our stock price may fluctuate in response to a number of events and factors, which may be the result of our business strategy or events beyond our control, including:

- developments concerning proprietary rights, including patents, by us or a competitor;
- announcements by us or our competitors of significant contracts, acquisitions, financings, commercial relationships, joint ventures or capital commitments;
- registration of additional shares of Class B common stock in connection with a strategic transaction;
- actual or anticipated fluctuations in our operating results;
- developments concerning our various strategic collaborations;
- lawsuits initiated against us or lawsuits initiated by us;
- announcements of acquisitions or technical innovations;
- potential loss or reduced contributions from distribution partners or merchant advertisers;
- changes in earnings estimates or recommendations by analysts;
- changes in the market valuations of similar companies; and
- changes in our industry and the overall economic environment.

In addition, the stock market in general, and the Nasdaq National Market and the market for online commerce companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of the listed companies. These broad market and industry factors may seriously harm the market price of our Class B common stock, regardless of our operating performance. In the past, following periods of volatility in the market, securities class action litigation has often been instituted against these companies. Litigation against us, whether or not judgment is entered against us, could result in substantial costs and potentially economic loss, and a diversion of our management's attention and resources, any of which could seriously harm our financial condition. Additionally, there can be no assurance that an active trading market of our Class B common stock will be sustained.

Because the shares of the preferred stock are convertible into shares of Class B common stock, volatility or depressed prices for our Class B common stock could have a similar effect on the value of the preferred stock. Holders who receive Class B common stock upon conversion also will be subject to the risk of volatility and depressed prices of our Class B common stock.

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**If we, or our existing stockholders, sell additional shares of our Class B common stock after this offering, the market price of our Class B common stock could decline.**

We have a substantial number of shares of Class B common stock that are eligible for resale following the offering, including:

- Upon completion of the offerings, we will have 21,421,539 shares of Class B common stock outstanding and 22,621,539 shares if the underwriters exercise their over-allotment option in full. We will have 16,452,159 shares of our common stock subject to lock-up for 90 days following the offering by executive officers, directors and certain of our stockholders.
- As of September 30, 2004, we had issued options for approximately 3,571,167 shares of Class B common stock, of which options for 970,244 shares were exercisable as of such date. We have also issued shares in connection with our initial financing and our prior acquisitions, of which 20,279,063 are eligible for resale under Rule 144.
- As of September 30, 2004, we had 111,578,461 shares of authorized but unissued shares of our Class B common stock that are available for future sale.

- Approximately 11,987,500 of our shares of Class A common stock and 8,725,104 of our shares of Class B common stock are subject to piggyback registration rights. Following the Name Development asset acquisition 403,587 shares of our Class B common stock will be subject to Form S-3 registration rights assuming that \$22.30 per share, the last reported sale price of our Class B common stock on February 8, 2005, is the applicable price for determining the number of shares to be issued; these shares will not be subject to lock-up following the acquisition. We also may enter into additional registration rights agreements in the future in connection with any subsequent acquisitions we may undertake. Any sales of our common stock under these registration rights arrangements with these stockholders could be negatively perceived in the trading markets and negatively affect the price of our common stock.

The market price of our Class B common stock could decline as a result of sales of a large number of shares of our Class B common stock in the market after this offering, or the perception that such sales could occur. These sales, or the possibility that these sales may occur, could make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate.

**Following this offering, conversion of our convertible preferred stock will dilute the interests of our existing Class B common stockholders.**

The conversion of some or all of the preferred stock will dilute the interests of our existing Class B common stockholders. Sales in the public market of shares of Class B common stock issued upon conversion would apply downward pressure on the prevailing market price. In addition, the very issuance of the preferred stock represents a future issuance, and perhaps a future sale, of our Class B common stock to be acquired upon conversion, which could depress trading prices for our Class B common stock.

**There is currently no public market for the preferred stock or the debentures, and the market price of the preferred stock may decline after you invest.**

There is currently no public market for the preferred stock or the debentures. Although we have applied for inclusion of the preferred stock on the Nasdaq National Market, there is no guarantee that these securities will be accepted for trading or if accepted that an active or liquid trading market will develop for the preferred stock. If an active trading market does not develop, the market price and liquidity of the preferred stock will be adversely affected. Even if an active trading market for the preferred stock were to develop, the preferred stock could trade for less than the public offering price, depending on many factors, including prevailing interest rates, our operating results and the markets for similar securities, and such active trading market could cease to continue at any time. In addition, if the preferred stock is exchanged for debentures, we are not obligated to list the debentures and cannot assure you that a market for the debentures will develop.

**We will require a significant amount of cash to meet the dividend obligations under the terms of the preferred stock. Our ability to generate cash depends on many factors beyond our control. If we cannot generate the required cash, we may not be able to make the preferred stock dividend payments.**

Our ability to meet the dividend payments under the terms of the preferred stock, and to fund planned capital expenditures and potential acquisitions will depend on our ability to generate cash in the future. Our ability to generate cash, to a certain extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control.

Our future financial results could be subject to fluctuations. Our business may not be able to generate sufficient cash flow from our operations or future financings may not be available to us in an amount sufficient to enable us to meet our payment obligations, including the accrued dividends under the terms of the preferred stock, or to fund our other liquidity needs. Our inability to meet our payment obligations would

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require us to pursue one or more alternative strategies, such as selling assets, refinancing, restructuring or selling equity capital. However, alternative strategies may not be feasible at the time or may not prove adequate, which could cause us to default on our obligations and would impair our liquidity.

**We may not be able to pay dividends on the preferred stock, which could impair the value of your investment.**

Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year or the fiscal year before which the dividend is declared. Our ability to pay dividends in the future will depend on our financial results, liquidity and financial condition. We can not be sure that we will have the surplus or profits to make periodic dividend payments, and we can not be sure that we will be able to pay the periodic installments of the dividend on the preferred stock.

**There may be tax consequences to you if we exchange your preferred stock for debentures.**

An exchange of the preferred stock for debentures will be a taxable event for federal income tax purposes which may result in tax liability to the holders without any corresponding receipt of cash by the holder. Such an exchange may be taxable as a dividend distribution to the extent of our current and accumulated earnings and profits, and may be subject to withholding tax if the exchanging stockholder is a Non-U.S. Holder.

**Our current and future payment obligations or indebtedness will have priority over a preferred stock liquidation preference and accrued dividend payment obligation in the event of our liquidation, dissolution or winding-up.**

The terms of the preferred stock do not contain any financial or operating covenants that would prohibit or limit us or our subsidiaries from incurring indebtedness or other liabilities, pledging assets to secure such indebtedness and liabilities, paying dividends, or issuing securities or repurchasing securities issued by us or any of our subsidiaries. The incurrence of indebtedness by us or our subsidiaries and, in particular, the granting of a security interest to secure the indebtedness could adversely affect our ability to pay accrued dividends under the terms of the preferred stock.

If we incur indebtedness, the holders of that debt will have prior rights with respect to any proceeds distributed in connection with any insolvency, liquidation, reorganization, dissolution or other winding-up of us. This may have the effect of reducing the amount of proceeds in connection with any insolvency, liquidation, reorganization or other winding-up of us paid to you as a holder of the preferred stock.

**Our founding executive officers control the outcome of stockholder voting, and there may be an adverse effect on the price of our Class B common stock due to the disparate voting rights of our Class A common stock and our Class B common stock.**

As of December 31, 2004, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, beneficially owned 96% of the outstanding shares of our Class A common stock, which shares represented 93% of the combined voting power of all outstanding shares of our capital stock. Upon completion of the offerings, these founding executive officers together will control 90% of the combined voting power of all outstanding shares of our capital stock, excluding the shares of Class B common stock issuable upon conversion of preferred stock. The holders of our Class A common stock and Class B common stock have identical rights except that the holders of our Class B common stock are entitled to one vote per share, while holders of our Class A common stock are entitled to twenty-five votes per share on all matters to be voted on by stockholders. This concentration of control could be disadvantageous to our other stockholders with interests different from those of these founding executive officers. This difference in the voting rights of our Class A common stock and Class B common stock could adversely affect the price of our Class B common stock to the extent that investors or any potential future purchaser of our shares of Class B common stock give greater value to the superior voting rights of our Class A common stock.

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Further, as long as these founding executive officers have a controlling interest, they will continue to be able to elect our entire board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, these founding executive officers will be in a position to continue to

control all fundamental matters affecting our company, including any merger involving, sale of substantially all of the assets of, or change in control of, our company.

The ability of these founding executive officers to control our company may result in our Class B common stock trading at a price lower than the price at which it would trade if these founding executive officers did not have a controlling interest in us. This control may deter or prevent a third party from acquiring us which could adversely affect the market price of our Class B common stock.

**Anti-takeover provisions may limit the ability of another party to acquire us, which could cause our stock price to decline.**

Our certificate of incorporation, as amended, our by-laws and Delaware law contain provisions that could discourage, delay or prevent a third party from acquiring us, even if doing so may be beneficial to our stockholders. In addition, these provisions could limit the price investors would be willing to pay in the future for shares of our Class B common stock. The following are examples of such provisions in our certificate of incorporation, as amended, or our by-laws:

- the authorized number of our directors can be changed only by a resolution of our board of directors;
- advance notice is required for proposals that can be acted upon at stockholder meetings;
- there are limitations on who may call stockholder meetings; and
- our board of directors is authorized, without prior stockholder approval, to create and issue blank check preferred stock.

We are also subject to Section 203 of the Delaware General Corporation Law, which provides, subject to enumerated exceptions, that if a person acquires 15% or more of our voting stock, the person is an interested stockholder and may not engage in business combinations with us for a period of three years from the time the person acquired 15% or more of our voting stock. The application of Section 203 of the Delaware General Corporation Law could have the effect of delaying or preventing a change of control of our company.



**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This prospectus includes forward-looking statements, principally in the sections entitled Prospectus Summary, Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operation and Business. All statements other than statements of historical facts contained in this prospectus, including statements regarding the benefits and risks associated with the pending Name Development asset acquisition, our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are forward-looking statements. The words believe, may, estimate, continue, anticipate, intend, expect and similar expressions, as they relate to us, are intended to identify forward-looking statements.

Any or all of our forward-looking statements in this prospectus may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described in Risk Factors. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this prospectus may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements.

Market data and forecasts used in this prospectus, including for example, estimates of the size and growth rates of the performance-based advertising and search marketing industries, the Internet advertising and transaction markets and the direct navigation markets generally, have been obtained from independent industry sources, unless otherwise noted. Forecasts and other forward-looking information obtained from these sources are subject to the same qualifications and the additional uncertainties accompanying any estimates of future market size.

You should not unduly rely on these forward-looking statements, which speak only as of the date of this prospectus. Unless required by law, we undertake no obligation to publicly update or revise any forward-looking statements to reflect new information or future events or otherwise. You should, however, review the factors and risks we describe in the reports we will file from time to time with the SEC after the date of this prospectus. See Where You Can Find More Information.

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**RATIO OF EARNINGS TO FIXED CHARGES AND PREFERRED STOCK DIVIDENDS**

The following table sets forth our deficiency of earnings to combined fixed charges and preferred stock dividends for the periods indicated. For the periods indicated below, earnings were insufficient to cover fixed charges. For this reason, no ratios are provided.

	Period from January 17, (inception) to December 31, 2003	Nine months ended September 30, 2004
	<u>                    </u>	<u>                    </u>
Loss from continuing operations before income taxes	\$ (3,253,664)	\$ (1,458,434)
Fixed charges:		
Interest expense		3,728
Assumed interest component of rental expenses <sup>(1)</sup>	120,333	133,892
	<u>                    </u>	<u>                    </u>
Total fixed charges	120,333	137,620
	<u>                    </u>	<u>                    </u>
Adjusted loss	(3,133,331)	(1,320,814)
	<u>                    </u>	<u>                    </u>
Total fixed charges	120,333	137,620
Preferred share dividends		
	<u>                    </u>	<u>                    </u>
Combined fixed charges and preferred stock dividend	120,333	137,620
	<u>                    </u>	<u>                    </u>
Deficiency of earnings to combined fixed charges and preferred stock dividends	\$ (3,253,664)	\$ (1,458,434)
	<u>                    </u>	<u>                    </u>

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<sup>(1)</sup> Estimated as one-third of operating lease expense.

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**USE OF PROCEEDS**

We estimate that the net proceeds from the sale of 200,000 shares of our 4.75% convertible exchangeable preferred stock in this offering will be approximately \$48.0 million, after deducting the estimated underwriting discounts of approximately \$1.8 million and estimated offering expenses of approximately \$215,000. If the underwriters exercise the over-allotment option in full, we estimate that the net proceeds will be approximately \$55.3 million. Concurrently with this offering, we are offering 8,000,000 shares of our Class B common stock. We estimate that the net proceeds from the Class B common stock offering will be approximately \$151.3 million, after deducting the estimated underwriting discounts and commissions of approximately \$8.0 million and estimated offering expenses of approximately \$685,000. If the underwriters exercise the over-allotment option in full, we estimate that the net proceeds from the Class B common stock offering will be approximately \$174.1 million. The closing of this offering is subject to the concurrent closing of the Name Development asset acquisition described in this prospectus and the closing of the concurrent Class B common stock offering.

We expect to use the net proceeds from this offering and our concurrent Class B common stock offering approximately as follows:

	<b>Amount</b>	<b>Percentage of Net Proceeds</b>
	<u>          </u>	<u>          </u>
	<b>(in millions)</b>	
Name Development asset acquisition	\$ 155.2	78%
Asset acquisition fees and expenses	0.5	
Working capital and other general corporate purposes, including potential future acquisitions	43.6	22%
	<u>          </u>	<u>          </u>
	\$ 199.3	100%
	<u>          </u>	<u>          </u>

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**PRICE RANGE OF CLASS B COMMON STOCK**

Our Class B common stock has been traded on the Nasdaq National Market under the symbol MCHX since March 31, 2004 when we completed our initial public offering at a price of \$6.50 per share. Prior to that time, there was no public market for our Class B common stock. As of September 30, 2004, there were approximately 144 holders of record of our Class B common stock. The following table sets forth, for the periods indicated, the high and low closing sales prices for Marchex's Class B common stock as reported on the Nasdaq National Market:

	<u>High</u>	<u>Low</u>
<b>Year ended December 31, 2004</b>		
First Quarter (Beginning March 31, 2004)	\$ 8.88	\$ 8.88
Second Quarter	\$ 13.28	\$ 9.50
Third Quarter	\$ 13.35	\$ 8.56
Fourth Quarter	\$ 21.00	\$ 12.40
<b>Year ended December 31, 2005</b>		
First Quarter (through February 8, 2005)	\$ 24.71	\$ 17.38

The last reported closing sale price of our Class B common stock on the Nasdaq National Market on February 8, 2005 was \$22.30 per share.

**DIVIDEND POLICY**

We currently intend to pay cash dividends on the preferred stock. Dividends on the preferred stock are cumulative, meaning that if they are not paid they continue to accrue and must be paid prior to the payment of any dividends on our common stock. For a discussion of dividends payable on the preferred stock, please see [Description of Preferred Stock](#) Dividends.

We have never declared or paid any cash dividends on shares of our common stock. Except for dividends payable on the preferred stock, we currently intend to retain our earnings for future growth and do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. Any future determination to pay dividends on such shares will be at the discretion of our board of directors and will depend on a number of factors, such as our results of operations, capital requirements, financial conditions, future prospects and other factors that the board of directors deems relevant.

## CAPITALIZATION

The following table sets forth our capitalization as of September 30, 2004 on:

- an actual basis;
- a pro forma basis to give effect to: (1) the sale of 8,000,000 shares of Class B common stock at the public offering price of \$20.00 per share, less \$8.7 million in estimated underwriting discounts and commissions and estimated offering expenses; and (2) the sale of 200,000 shares of preferred stock at the price of \$250 per share, less \$2.0 million in estimated underwriting discounts and commissions and estimated offering expenses; and
- a pro forma as adjusted basis to also give effect to the Name Development asset acquisition.

You should read this table in conjunction with our consolidated financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations, included elsewhere in this prospectus.

	As of September 30, 2004		
	Actual	Pro Forma	Pro Forma, as adjusted
Cash and cash equivalents	\$ 24,772,316	\$ 224,122,316	\$ 68,972,316
Stockholders' equity:			
4.75% convertible exchangeable preferred stock, \$.01 par value: 1,000,000 authorized; none issued and outstanding, actual and 200,000 issued and outstanding pro forma and pro forma as adjusted	\$	\$ 48,035,000	\$ 48,035,000
Common stock, \$.01 par value: 137,500,000 shares authorized;			
Class A: 12,500,000 shares authorized; 12,250,000 shares issued and 11,987,500 shares outstanding, actual, pro forma and pro forma as adjusted	122,500	122,500	122,500
Class B: 125,000,000 shares authorized; 13,421,539 shares issued and outstanding, actual, including 114,583 shares of restricted stock; 21,421,539 shares issued and outstanding pro forma; 21,825,126 shares issued and outstanding pro forma as adjusted	134,216	214,216	218,252
Treasury stock: 262,500 shares of Class A common stock actual, pro forma and pro forma as adjusted			
Additional paid-in capital	60,146,934	211,381,934	220,377,898
Deferred stock-based compensation	(690,937)	(690,937)	(690,937)
Accumulated deficit	(5,249,085)	(5,249,085)	(5,249,085)
Total stockholders' equity	54,463,628	253,813,628	262,813,628
Total capitalization	\$ 54,463,628	\$ 253,813,628	\$ 262,813,628

The above discussion and table exclude:

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- 4,938,603 shares of Class B common stock reserved for issuance and not exercised under our 2003 amended and restated stock incentive plan as of September 30, 2004 and 278,915 shares of Class B common stock reserved for issuance and not purchased under our 2004 employee stock purchase plan as of September 30, 2004. As of September 30, 2004, 3,571,167 shares were subject to outstanding options under our 2003 amended and restated stock incentive plan, which options are at a weighted average exercise price of \$4.02 per share.
- 120,000 shares of Class B common stock issuable upon the exercise of the warrants at an exercise price of \$8.45 per share issued to the underwriters in connection with our initial public offering in April 2004.
- 2,040,816 shares of our Class B common stock issuable upon conversion of the preferred stock.

In addition, the completion of the Class B common stock offering is not contingent upon the completion of the preferred stock offering.

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NAME DEVELOPMENT ASSET ACQUISITION

**Description of the Asset Acquisition**

On November 19, 2004, we entered into an agreement to acquire certain assets of Name Development Ltd., or Name Development, a corporation operating in the direct navigation market. Direct navigation is one of the methods that online consumers use to search for information, products or services online. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources. Name Development owns and maintains a portfolio of Web properties, that are generally reflective of online user search terms, descriptive keywords and keyword strings. Name Development has entered into agreements with advertising service providers to monetize its online user traffic with pay-per-click listings. As such, Name Development is able to connect online users searching for specific information with relevant advertisements.

Upon completion of the asset acquisition, we believe we will be among the leaders in the direct navigation market due to our proprietary ownership of online user traffic, which totaled more than 17 million unique visitors in November 2004. This user traffic is generated from a portfolio of Web properties that are generally reflective of commercially-relevant search terms in many of the Internet's most popular and dynamic vertical commerce categories and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000. Key vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, home and garden, Web and telecom services, education, and entertainment.

Name Development's revenues increased 260% from \$3.5 million for the fiscal year ended June 30, 2003 to \$12.5 million for the fiscal year ended June 30, 2004. For the corresponding periods, income from operations grew from \$3.2 million to \$12.6 million. For the nine months ended September 30, 2004, revenues were \$15.5 million and income from operations was \$14.9 million.

We expect to account for the Name Development asset acquisition as a business combination.

**Anticipated Benefits of the Asset Acquisition**

We believe that the Name Development asset acquisition will provide us with several benefits, including:

- ***A Defensible, Proprietary Source of Targeted Traffic.*** We believe that we will have an exclusive position due to the nature of Internet domain registration, which is similar to owning real-estate in that each Internet domain name is unique. The asset acquisition will provide us with Web properties that collectively generated more than 17 million unique visitors in November 2004. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000.
- ***Synergies with our Existing Search Engine Marketing Services Platform.*** We believe that our technology platform, combined with the Name Development asset acquisition, gives us an advantage in extending market share within the direct navigation market, expanding our participation in the search advertising market and in key commerce verticals. For example, we believe that: (1) there may be opportunities to work with monetization providers to improve the categorization and revenue generation of individual Web properties; (2) there may be opportunities to leverage our database of current search-related

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information to improve and automate selection and acquisition of complementary Web properties; (3) there may be opportunities to generate incremental user traffic to selected Web properties through leveraging our existing distribution network; (4) there may be opportunities to leverage our experience in working with a variety of online providers to add dynamic content and relevant advertiser listings, including product shopping listings and classified listings, to increase the user utility of the Web properties; and (5) there may



be opportunities, over time, to supplement existing listings on certain Web properties with our performance-based advertisements.

- ***Platform to Extend Expansion Initiatives.*** Over time, we intend to use the asset acquisition to supplement our planned expansion, both domestically and internationally.

### **Transaction Structure**

The aggregate consideration to be paid under the asset purchase agreement is an amount of cash equal to \$155.2 million plus the number of shares of our Class B common stock obtained by dividing \$9.0 million by the average of the last quoted sale price for shares of our Class B common stock on the Nasdaq National Market for the ten trading days immediately prior to the closing.

The asset purchase agreement contains customary representations and warranties and requires Name Development's sole stockholder to indemnify us for various liabilities arising under the agreement, subject to various limitations and conditions. At the closing, we will deposit into escrow for a period of eighteen months from the closing an amount of cash equal to \$24.6 million to secure the sole stockholder's indemnification and other obligations under the asset purchase agreement.

The asset acquisition is contingent on customary closing conditions, including the closing by us of financing sufficient to consummate such acquisition. If the closing does not occur on or before June 30, 2005, we may be required to pay Name Development a termination fee of \$1.5 million through a combination of cash and equity. We have also agreed to file a registration statement to register the shares of Class B common stock issued as the equity consideration thereunder or any shares of Class B common stock issued in connection with payment of the termination fee for resale on Form S-3 once we become eligible to file such a registration statement with the SEC.

**SUMMARY UNAUDITED PRO FORMA CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

The following tables present a summary of our unaudited pro forma condensed consolidated statements of operations for the year ended December 31, 2003 and for the nine months ended September 30, 2004. You should read this financial data together with Unaudited Pro Forma Condensed Consolidated Statements of Operations, Quarterly Results of Operations, Management's Discussion and Analysis of Financial Condition and Results of Operations, our historical audited consolidated financial statements and the related notes and the historical audited and unaudited financial statements of TrafficLeader, goClick.com and Name Development appearing elsewhere in this prospectus.

The unaudited pro forma condensed consolidated statement of operations data for the year ended December 31, 2003 give effect to: (1) our 2003 acquisitions of Enhance Interactive and TrafficLeader and our 2004 acquisition of goClick; and (2) our proposed Name Development asset acquisition and the offerings, as if they had all occurred on January 1, 2003. The unaudited pro forma condensed consolidated statements of operations for the year ended December 31, 2003 are based upon the historical results of operations of Marchex for the period from January 17, 2003 (inception) through December 31, 2003, the Predecessor for the period from January 1, 2003 through February 28, 2003, TrafficLeader for the period from January 1, 2003 through October 23, 2003 and goClick and Name Development for the year ended December 31, 2003.

The summary unaudited pro forma condensed consolidated statement of operations data are presented for illustrative purposes only and do not represent what our results of operations actually would have been if the transactions referred to above had occurred as of the dates indicated or what our results of operations will be for future periods.

In addition, the completion of the Class B common stock offering is not contingent upon the completion of the preferred stock offering.

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Year ended December 31, 2003

	Predecessor		Successor Periods			Pro Forma Marchex, Prior and Pending Acquisitions and Offering 2003
	Period					
	Period from January 1 to February 28, 2003	Marchex Period from January 17, (inception) to December 31, 2003	Pro Forma Marchex and Prior Acquisitions 2003	Pending Asset Acquisition and Offering 2003	Adjustments	
<b>Unaudited Pro Forma Statement of Operations:</b>						
Revenue	\$ 3,071,055	\$ 19,892,158	\$ 30,657,395	\$ 4,336,121	\$	\$ 34,993,516
Expenses:						
Service costs	1,732,813	11,292,070	18,528,420	1,238,536	(335,083) <sup>(1)</sup>	19,431,873
Sales and marketing	365,043	2,460,683	3,341,578			3,341,578
Product development	144,479	1,291,422	1,613,807			1,613,807
General and administrative	234,667	2,743,919	3,404,305	72,642		3,476,947
Acquisition-related retention consideration		283,269	283,269			283,269
Facility relocation						
Stock-based compensation	38,981	2,125,110	2,659,280			2,659,280
Amortization of intangible assets		3,023,408	6,186,641		14,588,333 <sup>(1)</sup>	20,774,974
Total operating expenses	2,515,983	23,219,881	36,017,300	1,311,178	14,253,250	51,581,728
Gain on sale of intangible assets, net				965,297		965,297
Income (loss) from operations	555,072	(3,327,723)	(5,359,905)	3,990,240	(14,253,250)	(15,622,915)
Other income (expense)	1,529	74,059	81,381	(11,233)		70,148
Income (loss) before provision for income taxes	556,601	(3,253,664)	(5,278,524)	3,979,007	(14,253,250)	(15,552,767)
Income tax expense (benefit)	224,082	(1,084,312)	(1,705,580)	441,588	(4,345,800) <sup>(2)</sup>	(5,609,792)
Net income (loss)	332,519	(2,169,352)	(3,572,944)	3,537,419	(9,907,450)	(9,942,975)
Accrual of convertible preferred stock dividends				2,375,000 <sup>(3)</sup>		2,375,000 <sup>(3)</sup>
Accretion of redemption value of redeemable convertible preferred stock		1,318,885	1,318,885			1,318,885
Net Income (loss) applicable to common stockholders <sup>(4)</sup>	\$ 332,519	\$ (3,488,237)	\$ (4,891,829)	\$ 1,162,419	\$ (9,907,450)	\$ (13,636,860)
<b>Other Financial Data:</b>						
Operating income before amortization (OIBA) <sup>(5)</sup>	\$ 594,053	\$ 1,820,795	\$ 3,486,016	\$ 3,990,240		\$ 7,811,339

<sup>(1)</sup>Represents the amortization of identifiable intangible assets associated with the Name Development asset acquisition, which are amortized over their useful lives ranging from 12 to 60 months, amortization of \$14.6 million in the first twelve months and \$25.5 million in the first twenty-one months following the acquisition. Name Development, for the year ended December 31, 2003 and the nine months ended September 30, 2004, recorded approximately \$335,000 and \$529,000, respectively, of amortization included in service costs related to the above noted intangible assets.

<sup>(2)</sup>Represents pro forma income tax expense (benefit) as though Name Development was taxed as a C corporation for the periods presented with an effective federal and state combined rate of 38%. Name Development is organized under the corporate law of the British Virgin Islands and is not subject to income tax in the British Virgin Islands. Name Development had e-commerce activities in several other governmental jurisdictions and as such, had recognized a provision for taxes in these foreign jurisdictions. A 1% change in the effective federal and state combined rate would modify income tax expense (benefit) by (\$103,000) for the twelve month period ended December 31, 2003 and \$46,000 for the nine months ended September 30, 2004.

<sup>(3)</sup>Represents preferred stock dividends related to the proposed preferred stock offering. Based upon a preferred stock offering of \$50.0 million with a 4.75% dividend rate, the accrual of the convertible preferred dividend for the twelve month period ended December 31, 2003 would be approximately \$2.4 million.

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<sup>(4)</sup>On February 3, 2005 we announced that in connection with the closing of the Name Development asset acquisition we intend to enter into (i) a new master agreement with Overture with respect to our direct navigation business, and (ii) a license agreement with Overture with respect to certain of Overture's patents, including but not limited to U.S. Patent No. 6,269,361, pursuant to which we will pay \$4.5 million, in an upfront payment (and an additional \$674,000 in certain circumstances) and a contingent royalty based on a discounted rate of 3% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016. We have not yet determined the accounting treatment of such payment obligations, including whether all or a portion of such amounts will be recorded as an expense or as a reduction of revenue or to the extent, if any, of the amounts that would be capitalized and no pro forma adjustments have been made on account thereof.

*Footnote continued on page 42.*

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The unaudited pro forma condensed consolidated statement of operations data for the nine months ended September 30, 2004 give effect to: (1) our 2004 acquisition of goClick; and (2) our proposed Name Development asset acquisition and the offerings, as if they had all occurred on January 1, 2003. The unaudited pro forma condensed consolidated statement of operations for the nine months ended September 30, 2004 are based upon the historical results of operations of Marchex for the nine months ended September 30, 2004, goClick for the period from January 1, 2004 through July 26, 2004 and for Name Development for the nine months ended September 30, 2004.

	Nine months ended September 30, 2004				
	Marchex	Pro Forma Marchex and Prior Acquisitions	Pending Asset Acquisition and Offering	Adjustments	Pro Forma Marchex, Prior and Pending Acquisitions and Offering
<b>Unaudited Pro Forma Statement of Operations:</b>					
Revenue	\$ 28,682,924	\$ 32,434,453	\$ 15,456,114	\$	\$ 47,890,567
Expenses:					
Service costs	18,142,886	20,473,056	1,242,744	(529,428) <sup>(1)</sup>	21,186,372
Sales and marketing	3,196,996	3,217,449			3,217,449
Product development	1,636,321	1,733,063			1,733,063
General and administrative	2,613,932	2,646,440	793,395		3,439,835
Acquisition-related retention consideration	374,858	374,858			374,858
Facility relocation	199,960	199,960			199,960
Stock-based compensation	721,403	721,403			721,403
Amortization of intangible assets	3,473,976	3,594,151		10,866,250 <sup>(1)</sup>	14,460,401
Total operating expenses	30,360,332	32,960,380	2,036,139	10,336,822	45,333,341
Gain on sale of intangible assets, net			1,507,498		1,507,498
Income (loss) from operations	(1,677,408)	(525,927)	14,927,473	(10,336,822)	4,064,724
Other income (expense)	218,974	224,470	2,408		226,878
Income (loss) before provision for income taxes	(1,458,434)	(301,457)	14,929,881	(10,336,822)	4,291,602
Income tax expense (benefit)	(118,016)	331,277	1,387,434	357,928 <sup>(2)</sup>	2,076,639
Net income (loss)	(1,340,418)	(632,734)	13,542,447	(10,694,750)	2,214,963
Accrual of convertible preferred stock dividends			1,781,250 <sup>(3)</sup>		1,781,250 <sup>(3)</sup>
Accretion of redemption value of redeemable convertible preferred stock	420,430	420,430			420,430
Net income (loss) applicable to common stockholders <sup>(4)</sup>	\$ (1,760,848)	\$ (1,053,164)	\$ 11,761,197	\$ (10,694,750)	\$ 13,283
<b>Other Financial Data:</b>					
Operating income before amortization (OIBA) <sup>(5)</sup>	\$ 2,517,971	\$ 3,789,627	\$ 14,927,473		\$ 19,246,528

<sup>(1)</sup> Represents the amortization of identifiable intangible assets associated with the acquisition of Name Development, which are amortized over their useful lives ranging from 12 to 60 months, amortization of \$14.6 million in the first twelve months and \$25.5 million in the first twenty-one months following the Name Development asset acquisition, for the year ended December 31, 2003 and the nine months ended September 30, 2004, recorded approximately \$335,000 and \$529,000, respectively, of amortization included in service costs related to the above noted intangible assets.

<sup>(2)</sup> Represents pro forma income tax expense (benefit) as though Name Development was taxed as a C corporation for the periods presented with an effective federal and state combined rate of 38%. Name Development is organized under the corporate laws of the British Virgin Islands and is not subject to income tax in the British Virgin Islands. Name Development had e-commerce activities in several other governmental jurisdictions and as such, had recognized a provision for taxes in these foreign jurisdictions. A 1% change in the effective federal and state combined rate would modify income tax expense (benefit) by (\$103,000) for the twelve month period ended December 31, 2003 and \$46,000 for the nine months ended September 30, 2004.

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<sup>(3)</sup>Represents preferred stock dividends related to the proposed preferred stock offering. Based upon a preferred stock offering of \$50.0 million with a 4.75% dividend rate, the accrual of the convertible preferred dividend for the nine months ended September 30, 2004 would be approximately \$1.8 million.

<sup>(4)</sup>On February 3, 2005 we announced that in connection with the closing of the Name Development asset acquisition we intend to enter into (i) a new master agreement with Overture with respect to our direct navigation business, and (ii) a license agreement with Overture with respect to certain of Overture's patents, including but not limited to U.S. Patent No. 6,269,361, pursuant to which we will pay \$4.5 million, in an upfront payment (and an additional \$674,000 in certain circumstances) and a contingent royalty based on a discounted rate of 3% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016. We have not yet determined the accounting treatment of such payment obligations, including whether all or a portion of such amounts will be recorded as an expense or as a reduction of revenue or to the extent, if any, of the amounts that would be capitalized and no pro forma adjustments have been made on account thereof.

*Footnote continued on page 42.*

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The following table provides a reconciliation of Income (loss) from operations and Net income (loss) applicable to common stockholders to the non-GAAP measure of OIBA.

	Year ended December 31, 2003					Nine months ended September 30, 2004			
	Predecessor	Successor Period				Successor Period			
	Period	Marchex			Pro Forma	Pro Forma			Pro Forma
	Period from January 1 to February 2003	Period from January 17, (inception) to December 31, 2003	Pro Forma and Prior Acquisitions 2003	Pending Acquisition and Offering 2003	Pro Forma Marchex, Prior and Pending Acquisitions and Offering 2003	Marchex	Pro Forma Marchex and Prior Acquisitions	Pending Asset Acquisition and Offering	Pro Forma Marchex, Prior and Pending Acquisitions and Offering
Operating income before amortization (OIBA) <sup>(5)</sup>	\$ 594,053	\$ 1,820,795	\$ 3,486,016	\$ 3,990,240	\$ 7,811,339	\$ 2,517,971	\$ 3,789,627	\$ 14,927,473	\$ 19,246,528
Stock-based compensation	(38,981)	(2,125,110)	(2,659,280)		(2,659,280)	(721,403)	(721,403)		(721,403)
Amortization of intangible assets		(3,023,408)	(6,186,641)		(20,774,974)	(3,473,976)	(3,594,151)		(14,460,401)
Income (loss) from operations	555,072	(3,327,723)	(5,359,905)	3,990,240	(15,622,915)	(1,677,408)	(525,927)	14,927,473	4,064,724
Other income (expense):	1,529	74,059	81,381	(11,233)	70,148	218,974	224,470	2,408	226,878
Income (loss) before provision for income taxes	556,601	(3,253,664)	(5,278,524)	3,979,007	(15,552,767)	(1,458,434)	(301,457)	14,929,881	4,291,602
Income tax expense (benefit)	224,082	(1,084,312)	(1,705,580)	441,588	(5,609,792)	(118,016)	331,277	1,387,434	2,076,639
Net income (loss)	332,519	(2,169,352)	(3,572,944)	3,537,419	(9,942,975)	(1,340,418)	(632,734)	13,542,447	2,214,963
Accrual of convertible preferred stock dividends				2,375,000	2,375,000			1,781,250	1,781,250
Accretion of redemption value of redeemable convertible preferred stock		1,318,885	1,318,885		1,318,885	420,430	420,430		420,430
Net income (loss) applicable to common stockholders	\$ 332,519	\$ (3,488,237)	\$ (4,891,829)	\$ 1,162,419	\$ (13,636,860)	\$ (1,760,848)	\$ (1,053,164)	\$ 11,761,197	\$ 13,283

<sup>(5)</sup> We report operating income before amortization (OIBA) that is a supplemental measure to GAAP. OIBA represents income (loss) from operations before: (1) stock-based compensation expense; and (2) amortization of intangible assets. This measure, among other things, is one of the primary metrics by which we evaluate the performance of our business. Additionally, management uses adjusted OIBA which excludes acquisition-related retention consideration as we view this as part of the earn-out consideration from the Enhance Interactive transaction. Adjusted OIBA is the basis on which our internal budgets are based and by which management is currently evaluated. Management believes that investors should have access to, and we are obligated to provide, the same set of tools that we use in analyzing our results. This non-GAAP measure should be considered in addition to results prepared in accordance with GAAP, and should not be considered in isolation, as a substitute for, or superior to, GAAP results. We believe this measure is useful to investors because it represents our consolidated operating results, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash expenses. OIBA has certain limitations in that it does not take into account the impact to our statement of operations of operations of certain expenses, including non-cash stock-based compensation associated with our employees and acquisition-related accounting. We endeavor to compensate for the limitations of the non-GAAP

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measure presented by providing the comparable GAAP measure with equal or greater prominence, GAAP financial statements and detailed descriptions of the reconciling items and adjustments, including quantifying such items, to derive the non-GAAP measure.



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MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and related notes appearing elsewhere in this prospectus. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including, but not limited to, those set forth under "Risk Factors" and elsewhere in this prospectus.*

## Overview

We provide technology-based merchant services that facilitate and drive growth in online transactions. We connect merchants with consumers who are searching for information, products and services on the Internet. Our platform of integrated performance-based advertising and search marketing services enables merchants to more efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and other selected Web properties.

We currently provide our merchant advertisers with the following technology-based services:

- ***Pay-Per-Click Services.*** We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories and other Web properties.
- ***Feed Management Services.*** We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers' databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. These feed management listings are ordered in the results based on relevance to user search queries. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web's largest search engines, product shopping engines and directories.
- ***Advertising Campaign Management Services.*** We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.
- ***Search Engine Optimization Services.*** We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date. Excluding the pending Name Development asset acquisition, we have completed three acquisitions since our inception including:

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On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive. eFamily was incorporated in Utah on November 29, 1999 under the name FocusFilter.com, Inc.

- On October 24, 2003, we acquired TrafficLeader which was incorporated in Oregon on January 24, 2000 under the name Sitewise Marketing, Inc.
- On July 27, 2004, we acquired goClick which was incorporated in Connecticut on October 25, 2000.

From January 17, 2003 (inception) through February 28, 2003, we were involved in business and product development, as well as financing and acquisition initiatives.

We currently have offices in Seattle, Washington; Provo, Utah; and Eugene, Oregon.

### **Prior Acquisitions**

#### *Enhance Interactive*

In February 2003, we acquired eFamily together with its wholly-owned subsidiary Enhance Interactive, a Provo, Utah-based company, for the following consideration:

- \$13.3 million in net cash and acquisition costs; plus
- Additional consideration in the form of a contingent earnings-based cash payment of up to \$13.5 million payable over two years, of which \$3.5 million has been paid and up to a maximum obligation of \$10.0 million remains.

The additional consideration consists of two components:

- A contingent earnings-based payment to the original stockholders ( *earn-out consideration* ); and
- A contingent earnings-based payment to certain employees ( *retention consideration* ).

These amounts are payable by us with respect to the years 2003 and 2004. We shall have no obligation with respect to a calendar year in the event that Enhance Interactive's earnings before taxes, excluding stock-based compensation and amortization of intangibles relating to the acquisition ( *earnings before taxes* ) do not exceed \$3.5 million for that calendar year. The threshold determination is calculated separately for each of the calendar years 2003 and 2004. For the 2003 calendar year, the total Enhance Interactive earnings-based payment obligation was approximately \$3.5 million. For the 2004 calendar year, the total Enhance Interactive earnings-based payment obligation was approximately \$6.2 million.

The contingent payment of *earn-out consideration*, payable to the original stockholders of Enhance Interactive, is calculated based on the formula of 69.44% of earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$12.5 million in aggregate. This payment obligation for each calendar year is conditioned on Enhance Interactive meeting the earnings threshold described above. Any payments made under this obligation will be accounted for as additional goodwill. For the 2003 calendar year, the *earn-out consideration* paid was approximately \$3.2 million. For the 2004 calendar year, the *earn-out consideration* payment obligation was approximately \$5.7 million.

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The contingent payment of retention consideration, payable to certain employees of Enhance Interactive, is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$1 million in aggregate. This payment obligation for each calendar year is also conditioned on Enhance Interactive meeting the earnings threshold described above. Any payments made under this obligation will be accounted for as compensation. For the 2003 calendar year, the retention consideration paid was approximately \$283,000. For the 2004 calendar year, the retention consideration payment obligation was approximately \$500,000.

In connection with this acquisition, we also issued nonqualified stock options to certain employees of Enhance Interactive, subject to their continued employment, to purchase up to an aggregate of 1,250,000 shares of our Class B common stock with an exercise price per share of \$0.75.

### *TrafficLeader*

In October 2003, we acquired TrafficLeader, a Eugene, Oregon-based company, for the following consideration:

- \$3.2 million in net cash and acquisition costs; plus

- 425,000 shares of Class B common stock, which had a redemption right prior to the closing of our initial public offering in April 2004; plus
- 137,500 shares of restricted Class B common stock which vest over a three-year period in six month installments of 16.67%; plus
- Additional consideration in the form of a contingent revenue-based cash incentive payment of up to \$1.0 million. For the 2004 calendar year, no additional consideration was due under this provision.

With respect to the second and third components, the total value of the shares and the redemption right was recorded at \$3.9 million. Prior to its expiration, the redemption right required us to buy back the 425,000 shares for \$8.00 per share, but only at the election of the holders of 75% of such shares in the event we had not completed a firm commitment initial public offering with gross proceeds of at least \$20.0 million prior to October 24, 2005.

Of the 137,500 restricted shares, 108,432 were issued to employees of TrafficLeader and valued at \$732,000, which amount is recorded as compensation expense over the associated employment period during which these shares vest.

In the event that on or prior to December 31, 2004, there is a change of control of TrafficLeader or of us, or both TrafficLeader's chief executive officer and chief technology officer either resign for good reason or are terminated without cause, or we take any action prior to the end of December 31, 2004, which makes it impractical to calculate or reconstruct the earn-out obligation, we will be obligated to pay the full amount of the \$1.0 million contingent payment obligation.

#### *goClick*

In July 2004, we acquired goClick, a Norwalk, Connecticut-based company for the following consideration:

- \$7.5 million in net cash and acquisition costs; plus
- 433,541 shares of Class B common stock.

The shares of Class B common stock were valued at \$9.55 per share, for accounting purposes, for an aggregate amount of \$4.1 million.

#### **Pending Name Development Asset Acquisition**

On November 19, 2004, we signed an asset purchase agreement with Name Development. Pursuant to this agreement, we will acquire substantially all of the assets of Name Development for the following consideration:

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- \$155.2 million in cash; plus
- \$9.0 million in shares of Class B common stock, based on the average of the last quoted sale price for shares of Class B common stock on the Nasdaq National Market for the 10 trading days immediately prior to the closing.

Under the terms of the agreement, we will acquire only the identified assets of Name Development, including its inventory of Internet domain names, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business. We will not assume any other obligations with respect to Name Development in this asset acquisition.

We expect to account for the Name Development asset acquisition as a business combination. The closing of the transaction is conditioned on a number of factors, including the closing by us of financing sufficient to consummate such acquisition. For more information on the asset acquisition, see Name Development Asset Acquisition.

## Consolidated Statements of Operations

Our consolidated statements of operations, stockholders' equity, and cash flows have been presented for:

- the period of January 17, 2003 (inception) to September 30, 2003;
- the period of January 17, 2003 (inception) to December 31, 2003; and
- the nine months ended September 30, 2004.

The statements of operations, stockholders' equity and cash flows have been presented for the Predecessor, Enhance Interactive:

- for the year ended December 31, 2002; and
- the period of January 1, 2003 to February 28, 2003.

Business planning and other activities related to our business began in late 2002. We were organized and incorporated in Delaware in January 2003. Included in the results of operations subsequent to our incorporation in January 2003 are reimbursements to certain founding executive officers for approximately \$86,000 in general and administrative pre-incorporation costs. Included in property and equipment are purchases from certain of our founding executive officers of approximately \$62,000 for the carrying value of the assets.

The assets, liabilities and operations of Enhance Interactive, TrafficLeader and goClick are included in our consolidated financial statements since the date of their respective acquisitions in February 2003, October 2003 and July 2004.

All significant inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions of Enhance Interactive, TrafficLeader and goClick being recorded at their estimated fair values on their respective acquisition dates. For the periods of: (1) February 28, 2003 through December 31, 2003; (2) October 24, 2003 through December 31, 2003; and (3) July 27, 2004 through September 30, 2004, all goodwill, intangible assets and liabilities resulting from the respective Enhance Interactive, TrafficLeader and goClick acquisitions have been recorded in our financial statements. Accordingly, our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive, are not comparable to the financial statements of Enhance Interactive presented for prior periods. The consolidated statements of operations, stockholders' equity, and cash flows reflecting Enhance Interactive's historical results have been presented for the year ended December 31, 2002 and the period from January 1, 2003 through February 28, 2003.

eFamily and its wholly-owned subsidiary Enhance Interactive are described as Enhance Interactive. In the consolidated financial statements, the statements of operations, stockholders' equity, and cash flows reflecting Enhance Interactive results have been presented as the Predecessor for the year ended December 31, 2002 and the period of January 1, 2003 to February 28, 2003.

**Presentation of Financial Reporting Periods**

For purposes of our discussion, we have included the results of operations of the Predecessor, Enhance Interactive. The comparative periods presented are for:

- the results of Enhance Interactive for the year ended December 31, 2002 (2002 period), compared to the combined results for the period of January 17, 2003 (inception) to December 31, 2003 and the results of Enhance Interactive for the period of January 1, 2003 to February 28, 2003 (2003 period); and
- the nine months ended September 30, 2003 (the combined periods of Marchex's results from January 17, 2003 (inception) to September 30, 2003 and the Predecessor's results for the period of January 1, 2003 to February 28, 2003), compared to the nine months ended September 30, 2004.



In the 2003 period, we have included the overlapping operating activities of Enhance Interactive and our operating activities for the period of January 17, 2003 (inception) through February 28, 2003 (the date we acquired Enhance Interactive). From our inception through the date of our acquisition of Enhance Interactive, we were involved in business and product development, as well as financing and acquisition initiatives. During this period we had no revenues. Accordingly, our activities were different from the operating activities of Enhance Interactive.

## **Revenue**

We currently generate revenue through our suite of services, including our pay-per-click services, feed management services, advertising campaign management services, search management services and search optimization services.

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services and feed management services. These primary sources amounted to greater than 91% of our revenues in all periods presented. Our secondary sources of revenue are our advertising campaign management services, search management services and search optimization services. These secondary sources amounted to less than 9% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

### ***Performance-Based Advertising Services***

In providing pay-per-click advertising services, we generate revenue upon our delivery of qualified click-throughs to our merchant advertisers. These merchant advertisers pay us a designated transaction fee for each click-through, which occurs when an online user clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes search engines, directories, destination sites and other targeted Web-based content.

In providing feed management services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included in search engine, directory and product shopping engine results within our distribution network. Generally, the feed management listings are presented in a different section of the a Web page than the pay-per-click listings. For this service, revenue is generated when an online user clicks on a feed management listing from search engine, directory or product shopping engine results. Each click-through on an advertisement listing represents a completed transaction for which the merchant advertiser pays for on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

### ***Search Marketing Services***

Merchant advertisers pay us additional fees for services such as advertising campaign management services and search optimization services. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers. We may also charge initial set-up or inclusion fees as part of our services. Total revenue from these services accounted for less than 9% of total revenue in all periods presented.

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Banner advertising revenue is primarily based on a fixed fee per click and is generated and recognized on click-through activity. In limited cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

Non-refundable account set-up fees are paid by merchant advertisers and are recognized ratably over the longer of the term of the contract or the average expected merchant advertiser relationship period, which generally ranges from twelve months to more than two years.

Other inclusion fees are generally associated with monthly or annual subscription-based services where a merchant advertiser pays a fixed amount to be included in our index of listings or our distribution partners' indexes of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

### *Industry and Market Factors*

We enter into agreements with various distribution partners to provide distribution for the URL strings and advertisement listings of our merchant advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount per click-through on these listings. The level of click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. Our current growth will be impacted by our ability to increase our distribution, which impacts the number of Internet users who have access to our merchant advertisers' listings and the rate at which our merchant advertisers are able to convert clicks from these Internet users into completed transactions, such as a purchase or sign up. Our current growth also depends on our ability to continue to increase the number of merchant advertisers who use our services and the amount these merchant advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular, it is difficult to project the number of click-throughs we will deliver to our merchant advertisers and how much merchant advertisers will spend with us, and it is even more difficult to anticipate the average revenue per click-through.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage and seasonal purchasing cycles of many merchant advertisers. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results.

### **Service Costs**

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

- user acquisition costs;
- amortization of intangible assets;
- credit card processing fees;
- network operations;
- serving our search results;

- maintaining our Web sites;
- network fees;
- fees paid to outside service providers;
- delivering customer service;
- depreciation of our Web site and network equipment;
- colocation service charges of our Web site equipment;
- bandwidth, and software license fees;
- salaries of related personnel; and
- stock-based compensation of related personnel.

### *User Acquisition Costs*

For the periods presented the largest component of our service costs consist of user acquisition costs that relate primarily to payments to our distribution partners for access to their online user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their sites and indexes. The primary economic structure of our distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that we may use to a lesser degree include:

- fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid click-throughs; and
- a combination arrangement with both fixed and variable amounts.

Our method of expensing user acquisition costs is based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed at the greater of: (1) pro-rata over the term the fixed payment covers; or (2) usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payments based on a percentage of revenue, number of paid click-throughs or other metrics are generally expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

### **Sales and Marketing**

Sales and marketing expenses consist primarily of:

- payroll and related expenses for personnel engaged in marketing and sales functions;
- advertising and promotional expenditures; and
- cost of systems used to sell to and serve merchant advertisers.

### **Product Development**

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Internet sites and services.

Our research and development expenses include:

- compensation and related expenses;
- costs of computer hardware and software; and
- costs incurred in developing features and functionality of the services we offer.

For the periods presented, substantially all of our product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with the American Institute of Certified Public Accountants' Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

#### **General and Administrative**

General and administrative expenses consist primarily of:

- payroll and related expenses for executive and administrative personnel;
- professional services, including accounting, legal and insurance;

- bad debt provisions;
- facilities costs; and
- other general corporate expenses.

#### **Acquisition-Related Retention Consideration**

Acquisition-related retention consideration results from our contingent, earnings-based payment obligation to certain employees of Enhance Interactive for each of the calendar years 2003 and 2004, pursuant to the terms of the merger agreement. See subsection Prior Acquisitions above. We will have no obligation with respect to a year in the event that Enhance Interactive's earnings before taxes do not exceed \$3.5 million for that calendar year. The threshold determination is calculated separately for each of calendar years 2003 and 2004.

The contingent payment obligation is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$1.0 million in the aggregate. To the extent we make any payments under this obligation, we will account for such amounts as compensation. For the 2003 calendar year, the retention consideration was approximately \$283,000. For the nine months ended September 30, 2004, we recorded an additional \$375,000 in retention-related consideration as compensation expense for such period. The actual amount for the calendar year 2004 has not yet been determined.

#### **Stock-Based Compensation**

Stock-based compensation consists of the following components:

- the intrinsic value of employee option and restricted stock issuances in cases where the fair value of the underlying stock was greater than the exercise price on the date of the grant;
- the fair value of non-employee option issuances; and
- the amount by which the fair value of our Class B common stock exceeds the exercise price at the end of the period for certain options.

We used variable accounting for the options to purchase 125,000 shares of our Class B common stock that were issued under our stock incentive plan. These options were held in escrow until February 28, 2004 as security for the indemnification obligations under the Enhance Interactive merger agreement, and these options were subject to forfeiture during the escrow period. We accounted for these options as variable awards until February 28, 2004.

#### **Amortization of Intangibles**

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Amortization of intangible assets relates to intangible assets identified in connection with our acquisitions.

Intangible assets identified in connection with the purchase of Enhance Interactive were valued at \$8.4 million at the acquisition date of February 28, 2003. Intangible assets identified in connection with the purchase of TrafficLeader were valued at \$1.3 million at the acquisition date of October 24, 2003. Intangible assets identified in connection with the purchase of goClick were valued at \$3.3 million at the acquisition date of July 27, 2004.

The intangible assets have been identified as:

- non-competition agreements;
- trade and Internet domain names;
- distributor relationships;
- merchant advertising customer base relationships; and
- acquired technology.



These assets are amortized over useful lives ranging from 12 to 42 months.

### **Provision for Income Taxes**

For income tax purposes, we utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized.

As of September 30, 2004, we had net operating loss, or NOL, carryforwards of \$1.8 million, which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that the utilization of the approximately \$1.8 million of carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

### **Initial Public Offering**

On March 30, 2004, we commenced an initial public offering of 4.6 million shares of our Class B common stock. The closing of our initial public offering took place on April 5, 2004. The proceeds of our initial public offering, net of cash offering expenses, were approximately \$27.2 million. In connection with our initial public offering, those underwriters were also granted warrants, exercisable over a four-year period commencing April 5, 2005 date and ending April 5, 2009, to purchase 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share. Net proceeds have been or are expected to be used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations and working capital and other general corporate purposes.

### **Accretion to Redemption Value of Redeemable Convertible Preferred Stock**

All 6,724,063 shares of our outstanding Series A redeemable convertible preferred stock were automatically converted into 6,724,063 shares of Class B common stock upon the closing of our initial public offering in April 2004. Prior to this conversion, holders of our Series A redeemable convertible preferred stock were entitled to receive annual cumulative dividends at the per annum rate of 8% of the original purchase price per share when and if declared by our board of directors. Upon the conversion of the Series A redeemable convertible preferred stock, dividend rights were automatically terminated and any rights to past dividends were forgiven.

Prior to the automatic conversion, we accounted for the difference between the carrying amount of the redeemable preferred stock and the redemption amount by increasing the carrying amount for periodic accretion using the interest method, so that the carrying amount was equal to redemption amount at the earliest redemption date.

### **Results of Operations**

*Comparison of the year ended December 31, 2002 (2002 period), to the combined periods of January 1 to February 28, 2003 and January 17 (inception) to December 31, 2003 (2003 period)*

**Revenue.** Revenue increased 128%, from \$10.1 million in the 2002 period to \$23.0 million in the 2003 period. This increase was primarily attributable to an increase in performance-based advertising services from \$9.3 million in the 2002 period to \$21.7 million in the 2003 period. Of this \$12.4 million increase, 34% related to an increase in the number of merchant advertisers, while 66% related to an increase in the average revenue per merchant advertiser.

We believe the increase in revenue is primarily attributable to the growth of our revenue resulting from our existing distribution partners, the increased number of searches and resulting click-throughs performed by users of our services, and the addition of new distribution partners and merchant advertisers. The number of our distribution partners increased from approximately 290 in December 2002 to approximately 410 in December 2003. We also believe the foregoing factors, combined with our sales efforts and improved operational controls, have contributed to the increase in the number of merchant advertisers. \$1.2 million of the increase in revenue in the 2003 period is also attributable to the acquisition of TrafficLeader in October 2003, which added 11 unique distribution partners and more than 280 merchant advertisers. TrafficLeader's operating results were included in the 2003 period as of the acquisition date of October 24, 2003.

### *Expenses*

*Service Costs.* Service costs increased 106%, from \$6.3 million in the 2002 period to \$13.0 million in the 2003 period. The net increase in costs was mainly attributable to an increase in payments to distribution partners of \$6.2 million, an increase in credit card processing fees of \$333,000, an increase in personnel costs of \$171,000, a decrease in technology licensing costs of \$104,000, and an increase in facility and other costs of \$91,000. This net increase related to a greater number of searches, an increase in database and hardware capacity requirements as a result of an increase in our distribution partner base and corresponding number of searches, an increase in the number of personnel required to support our services and increased fees paid to outside service providers. Service costs represented 63% of revenue in the 2002 period and 57% of revenue in the 2003 period. As a percentage of revenue, the decrease in service costs for the 2003 period compared to the 2002 period was primarily a result of network operation expenses containing fixed costs and also not increasing at a higher rate than revenue. The decrease in the 2003 period was partially offset by the impact of \$943,000 in service costs and the impact as a percentage of revenue resulting from the October 2003 acquisition of TrafficLeader and its feed management services. Payments to feed management services distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage.

*Sales and Marketing.* Sales and marketing expense increased 55%, from \$1.8 million in the 2002 period to \$2.8 million in the 2003 period. As a percentage of revenue, sales and marketing expenses were 18% in the 2002 period and 12% in the 2003 period. The increase in dollars was primarily related to an increase in personnel costs of \$614,000, primarily due to an increase in the number of employees, including \$72,000 resulting from the acquisition of TrafficLeader in October 2003. The remaining increase is related to increases in outside marketing activities, rent, travel and other operating costs arising from operations in multiple jurisdictions.

*Product Development.* Product development expenses increased 77%, from \$812,000 in the 2002 period to \$1.4 million in the 2003 period. As a percentage of revenue, product development expenses were 8% in the 2002 period and 6% in the 2003 period. As a percentage of revenue, the decrease in product development expenses in the 2003 period compared to the 2002 period was primarily a result of the allocation of product development expenses over a larger revenue base. The increase in dollars was primarily due to an increase in personnel costs of \$461,000, primarily due to an increase in the number of employees, including \$40,000 resulting from the acquisition of TrafficLeader in October 2003, and rent and other operating expenses of \$163,000 arising from operations in multiple jurisdictions.

*General and Administrative.* General and administrative expenses increased 205%, from \$977,000 in the 2002 period to \$3.0 million in the 2003 period. As a percentage of revenue, general and administrative expenses were 10% in the 2002 period and 13% in the 2003 period. The increase in the dollars was due to an increase in personnel costs of \$640,000, an increase in professional fees of \$617,000, an increase in travel of \$288,000, an increase in insurance of \$74,000, an increase in bad debt expense of \$126,000, and an increase in facility and other operating expenses of \$257,000.

Many of these costs and increases in costs as a percentage of revenue in the 2003 period result from operating in multiple jurisdictions commencing in 2003 and increased operating activity, including approximately \$136,000 in general and administrative expenses from the acquisition of TrafficLeader in October 2003.



*Acquisition-Related Retention Consideration.* Acquisition-related retention consideration increased from zero in the 2002 period to \$283,000 in the 2003 period. During the 2003 period, the components of acquisition-related retention consideration were service costs of \$34,000, sales and marketing of \$96,000, product development of \$104,000 and general and administrative of \$49,000. The acquisition-related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and is equal to 5.56% of Enhance Interactive's earnings before taxes in excess of \$3.5 million for the 2003 period of which \$283,000, including \$23,000 of employer-related payroll taxes, has been recorded in 2003. We accounted for this payment amount as compensation.

With respect to calendar year 2004, we will be obligated to pay additional acquisition-related retention consideration to certain employees of Enhance Interactive if Enhance Interactive has earnings before taxes in excess of \$3.5 million. This acquisition-related retention consideration will be equal to 5.56% of Enhance Interactive's earnings before taxes for the 2004 period. The acquisition-related retention consideration for the calendar years 2003 and 2004 is subject to an aggregate maximum of \$1 million. We will account for any payment amount as compensation.

*Stock-Based Compensation.* The amortization of stock-based compensation increased 493%, from \$365,000 in the 2002 period to \$2.2 million in the 2003 period. During the 2002 period, the components of stock-based compensation were service costs of \$3,000, sales and marketing of \$149,000, product development of \$57,000 and general and administrative of \$156,000. The 2002 period amount related primarily to the January 2002 sale of 2,031,666 shares to employees for cash consideration totaling \$10,000; \$357,000 in stock-based compensation was recorded in connection with the share issuance based on the difference between the cash consideration and the estimated fair value. During the 2003 period, the components of stock-based compensation were service costs of \$10,000, sales and marketing of \$423,000, product development of \$279,000 and general and administrative of \$1.5 million.

Amounts in the 2003 period related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair value of the shares at the date of grant, and \$112,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader. The 2003 period also includes \$781,000 of stock-based compensation for options to purchase 125,000 shares of Class B common stock, which were being held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period on February 28, 2004. Accordingly, we have accounted for these options as variable awards.

Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the vesting period thereof. Increases or decreases in the fair value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense.

*Amortization of Identifiable Intangibles.* Intangible amortization expense increased from zero in the 2002 period to \$3.0 million in the 2003 period as a result of amortizing identifiable intangibles associated with the purchase of Enhance Interactive and TrafficLeader. Of the \$3.0 million intangible amortization expense in the 2003 period, \$123,000 was associated with the acquisition of TrafficLeader. During the 2003 period, the components of amortization of intangibles were service costs of \$2.2 million, sales and marketing of \$348,000, and general and administrative of \$458,000.

Our application of purchase accounting resulted in the recording of all assets and liabilities from our acquisitions of Enhance Interactive and TrafficLeader at their estimated fair values on the acquisition dates of February 28, 2003 and October 24, 2003, respectively. For the period of February 28, 2003, through December 31, 2003, all goodwill, identifiable intangible assets and liabilities resulting from the Enhance Interactive and TrafficLeader acquisitions have been recorded in our financial statements. The identified intangibles amounted to \$9.7 million,

including \$1.3 million associated with TrafficLeader, and are being amortized over a range of useful lives of 12 to 42 months.

Our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive are not comparable to the financial statements of Enhance Interactive presented for prior periods.

*Other Income.* Other income increased from \$5,000 in the 2002 period to \$76,000 in the 2003 period. Interest income and the adjustment to the fair value of the TrafficLeader redemption obligation account for primarily all of the increase. Interest income includes interest on cash balances. Interest income increased from \$5,000 in the 2002 period to \$47,000 in the 2003 period due to an increase in the average cash balance for the period resulting from our Series A redeemable convertible preferred stock financing.

The adjustment to fair value of the redemption obligation went from zero in the 2002 period to \$26,000 in the 2003 period. As of the date of acquisition of TrafficLeader, a redemption obligation was recorded at fair value in the amount of \$81,000. The \$26,000 adjustment reflects the decrease in the fair value of the obligation to \$55,000 as of December 31, 2003. This obligation was eliminated with the closing of our initial public offering in April 2004.

*Income Taxes.* The income tax benefit increased from \$143,000 in the 2002 period to \$860,000 in the 2003 period. The 2002 period effective tax rate benefit of 61% differed from the expected effective rate of 34% primarily due to our reversing \$208,000 of the valuation allowance on deferred tax assets and due to the effective rate impact of the \$133,000 of non-deductible stock-based compensation during the 2002 period.

During the 2002 period, Enhance Interactive determined that it was more likely than not, based on improved operating performance, that it would realize all of the available net deferred tax assets. The income tax effective rate was 32% in the 2003 period. This differed from the expected rate of 34% primarily due to state income taxes offset by non-deductible stock compensation amounts.

The 2003 period was also impacted by the following factors:

- On February 28, 2003 and October 24, 2003, in connection with the application of purchase accounting for our respective acquisitions of Enhance Interactive and TrafficLeader, we recorded net deferred tax liabilities of approximately \$3.5 million, including \$482,000 associated with the acquisition of TrafficLeader, relating to the difference in the book basis and tax basis of its assets and liabilities.
- Approximately \$3.6 million of these deferred tax liabilities, including \$479,000 associated with the acquisition of TrafficLeader, related to the book basis versus tax basis of the identifiable intangible assets in the acquisitions totaling approximately \$9.7 million.

During the period of January 1 through February 28, 2003, as a result of a tax deduction from stock option exercises, Enhance Interactive recognized a tax-effected benefit of approximately \$231,000, which was recorded as a credit to additional paid in capital.

*Accretion to Redemption Value of Redeemable Convertible Preferred Stock.* The accretion to redemption value of preferred stock was \$1.3 million in the 2003 period. The accretion to the redemption value recorded during the period is based upon 6,724,063 shares of Series A preferred stock outstanding as of December 31, 2003 with a dividend rate of 8% per annum.

*Net Income (Loss) Applicable to Common Stockholders.* Net loss applicable to common stockholders increased from \$90,000 in the 2002 period to \$3.2 million in the 2003 period. The increase was primarily attributable to an increase in operating income offset by an increase of \$3.0 million in amortization of intangible assets and an increase of \$1.8 million in stock-based compensation.

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*Comparison of the combined periods of January 1, 2003 to February 28, 2003 and January 17, 2003 (inception) to September 30, 2003 (the nine months ended September 30, 2003) to the nine months ended September 30, 2004*

**Revenue.** Revenue increased 85%, from \$15.5 million in the nine months ended September 30, 2003 to \$28.7 million in the same period in 2004. This increase was primarily attributable to our performance-based advertising services, which increased by approximately \$12.7 million in the nine months ended September 30, 2004. Of this increase approximately 77% related to an increase in the average revenue per merchant advertiser, while approximately 23% related to an increase in the number of merchant advertisers.

We believe the increase in revenue is primarily attributable to the growth of our revenue resulting from our existing distribution partners, the increased number of searches and resulting click-throughs performed by users of our services, and the addition of new distribution partners and merchant advertisers. The number of our distribution partners was approximately 390 in September 2003 and approximately 440 in September 2004. We also believe the foregoing factors, combined with our sales efforts and improved operational controls, have contributed to the increase in the average revenue per merchant advertiser. The increase in revenue in the nine months ended September 30, 2004 is also attributable to the acquisition of TrafficLeader in October 2003, which added 11 unique distribution partners and more than 280 merchant advertisers and the acquisition of goClick in July 2004 which added more than 40 unique distribution partners and more than 5,000 unique merchant advertisers. The operating results of TrafficLeader and goClick were included as of the acquisition dates of October 24, 2003 and July 27, 2004, respectively.

Our growth rate will depend in part on our ability to increase the number of click-throughs performed by users of our service, primarily through our distribution partners. If we do not renew our distribution partner agreements or replace traffic lost from terminated distribution agreements with other sources or if our distribution partners' search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our growth rate will also depend in part on our ability to increase the number and volume of transactions with merchant advertisers. We believe this is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers.

### **Expenses**

**Service Costs.** Service costs increased 112%, from \$8.5 million in the nine months ended September 30, 2003 to \$18.1 million in the same period in 2004. This increase was primarily attributable to an increase of \$8.1 million in payments to distribution partners, an increase in personnel costs of \$942,000, an increase in facility and other costs of \$310,000, an increase in payment processing fees of \$163,000 and an increase in production technology and bandwidth costs of \$118,000.

Service costs as a percentage of revenue were 63% in the nine months ended September 30, 2004 as compared to 55% in the same period in 2003. As a percentage of revenue, the increase in service costs for the nine months ended September 30, 2004 period as compared to the same period in 2003 was primarily a result of the impact as a percentage of revenue from the service cost level from the October 2003 acquisition of TrafficLeader and their feed management services. TrafficLeader's service costs, of which feed management services is the primary component, were 78% of TrafficLeader's revenue for the nine months ended September 30, 2004. Payments to feed management services distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage. To the extent that payments to feed management services distribution partners make up a larger percentage of future operations, we expect that service costs will increase as a percentage of revenue. goClick's operating activities are in the process of being integrated with our other operations. goClick's service costs did not have a significant percentage impact on the consolidated service cost percentage of revenue.

Approximately \$5.3 million and \$1.2 million of the total increase in service costs for the nine months ended September 30, 2004 was attributable to the October 2003 acquisition of TrafficLeader and the July 2004





acquisition of goClick, respectively, which were not included in the same period in 2003. The increase in services also resulted from a greater number of searches, an increase in database and hardware capacity requirements as a result of an increase in our distribution partner base and corresponding number of searches, an increase in the number of personnel required to support our services and an increase in fees paid to outside service providers. We expect that service costs will continue to increase in absolute dollars, since we anticipate expanding our operations.

*Sales and Marketing.* Sales and marketing expenses increased 63%, from \$2.0 million in the nine months ended September 30, 2003 to \$3.2 million in the same period in 2004. The increase in dollars was primarily attributable to an increase in personnel costs of \$893,000, an increase in travel costs of \$166,000 and an increase in other expenses of \$181,000. As a percentage of revenue, sales and marketing expenses were 13% and 11% for the nine months ended September 30, 2003 and 2004, respectively. We expect that sales and marketing expenses will increase in absolute dollars in connection with any revenue increase, to the extent that we also increase our marketing activities.

*Product Development.* Product development expenses increased 65%, from \$989,000 in the nine months ended September 30, 2003 to \$1.6 million in the same period in 2004. The increase in dollars was primarily attributable to an increase in personnel costs of \$530,000, an increase in travel costs of \$39,000 and an increase in other expenses of \$78,000. As a percentage of revenue, the product development expenses were 6% for both the nine months ended September 30, 2003 and 2004. We expect that product development expenses will increase in absolute dollars as we increase the number of personnel and consultants to enhance our service offerings.

*General and Administrative.* General and administrative expenses increased 27%, from \$2.1 million in the nine months ended September 30, 2003 to \$2.6 million in the same period in 2004. As a percentage of revenue, general and administrative expenses decreased to 9% in the nine months ended September 30, 2004 as compared to 13% in the same period in 2003. As a percentage of revenue, the decrease in general and administrative expenses in the nine months ended September 30, 2004 as compared to the same period in 2003 was primarily a result of general and administrative expenses being compared to a larger revenue base.

The net increase in the dollars was primarily due to an increase in personnel costs of \$754,000, a decrease in travel costs of \$106,000, an increase in insurance of \$74,000, an increase in bad debt expense of \$133,000 and a decrease in other expenses of \$292,000. Many of these costs in the nine months ended September 30, 2004 result from operating in multiple jurisdictions commencing in 2003 and increased operating activity, including the acquisitions of TrafficLeader in October 2003 and goClick in July 2004. We expect that our general and administrative expenses will increase in absolute dollars to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance.

*Acquisition-Related Retention Consideration.* Acquisition-related retention consideration increased 100%, from zero in the nine months ended September 30, 2003 to \$375,000 in the same period in 2004. A ratable proportion of the annual estimated acquisition-related retention consideration was recorded for the nine months ended September 30, 2004. During the nine months ended September 30, 2004, the components of acquisition-related retention consideration were estimated based on forecasts of the Enhance Interactive earn-out calculations. Estimated allocations were made as follows: service costs of \$45,000, sales and marketing of \$127,000, product development of \$138,000, and general and administrative of \$65,000.

The acquisition-related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and is equal to 5.56% of Enhance Interactive's earnings before taxes in excess of \$3.5 million for the 2004 period of which \$375,000 has been recorded as acquisition-related retention consideration including employer payroll-related taxes. We will account for any payment amount as compensation. The acquisition-related retention consideration for the calendar years 2003 and 2004 is subject to an aggregate maximum of \$1.0 million.

*Facility Relocation.* In March 2004, we entered into a sublease agreement for new and larger office facilities in Seattle, Washington, and we relocated from our original office facilities also located in Seattle, Washington. In March 2004, we accrued lease and related costs of \$230,000 for the estimated future obligations of non-cancelable lease and other payments for the original facilities. In the third quarter of 2004, we reduced the lease and related costs accrual by \$30,000 based on a revised estimate for subtenant income. The remaining lease obligations for the original facilities extend through June 30, 2006 and totaled \$219,000 as of September 30, 2004. As of September 30, 2004, we estimate the net sublease income to be approximately \$57,000 over the remaining life of the lease.

The remaining lease accrual is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

*Stock-Based Compensation.* The amortization of stock-based compensation decreased 56%, from \$1.6 million in the nine months ended September 30, 2003 to \$721,000 in the same period in 2004. During the nine months ended September 30, 2004, the components of stock-based compensation were service costs of \$9,000, sales and marketing of \$124,000, product development of \$47,000 and general and administrative of \$541,000. Amounts in the 2004 period related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair market value at the date of grant and \$341,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader.

The nine months ended September 30, 2003 includes \$603,000 of stock-based compensation for 125,000 options issued that were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period on February 28, 2004. Accordingly, we have accounted for these options as variable awards during the escrow period. Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair market value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the option's vesting period. Increases or decreases in the fair market value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense.

*Amortization of Intangibles.* Intangible amortization expense increased 71%, from \$2.0 million for the nine months ended September 30, 2003 to \$3.5 million in the same period in 2004. The increase is associated with the acquisitions of Enhance Interactive, TrafficLeader, and goClick. During the nine months ended September 30, 2004, the components of amortization of intangibles were service costs of \$2.4 million, sales and marketing of \$533,000 and general and administrative of \$494,000.

Our purchase accounting resulted in all assets and liabilities from our acquisition of Enhance Interactive, TrafficLeader and goClick being recorded at their estimated fair values on the acquisition dates of February 28, 2003, October 24, 2003, and July 27, 2004, respectively. For the period from February 28, 2003 through September 30, 2004, all goodwill, identifiable intangible assets and liabilities resulting from the Enhance Interactive, TrafficLeader and goClick acquisitions have been recorded in our financial statements. The identified intangibles amounted to approximately \$13.0 million and are being amortized over a range of useful lives of 12 to 42 months. Our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive are not comparable to the financial statements of Enhance Interactive presented for prior periods. We may acquire identifiable intangible assets as part of future acquisitions and, if so, we expect that our intangible amortization will increase in absolute dollars.

*Other Income.* Other income increased 525%, from \$35,000 in the nine months ended September 30, 2003 to \$219,000 in the same period in 2004. The increase was primarily attributable to an increase in interest income of \$130,000 and the adjustment to fair value of the TrafficLeader redemption obligation of \$55,000 in the nine months ended September 30, 2004 as compared to the same period in 2003. Interest income increased as a result of the impact of the initial public offering on the average cash balances in the nine months ended September 30, 2004.



*Income Taxes.* The income tax benefit decreased 79%, from \$559,000 in the nine months ended September 30, 2003 to \$118,000 in the same period in 2004.

In the nine months ended September 30, 2003, the effective tax rate benefit of 34% equaled the expected rate but was impacted by state income taxes in addition to non-deductible stock compensation amounts. The income tax effective rate benefit was 8% in the nine months ended September 30, 2004. This differed from the expected rate of 34% primarily due to non-deductible stock compensation amounts. The periods were also impacted by the following factors:

- On February 28, 2003 and October 24, 2003, in connection with the purchase accounting for the respective acquisitions of Enhance Interactive and TrafficLeader, we recorded net deferred tax liabilities in the amount of approximately \$3.5 million, including \$482,000 associated with the acquisition of TrafficLeader, relating to the difference in the book basis and tax basis of its assets and liabilities.
- Approximately \$3.6 million of these deferred tax liabilities, including \$479,000 associated with the acquisition of TrafficLeader, related to the book basis versus tax basis of the identifiable intangible assets in the acquisitions totaling approximately \$9.7 million.
- On July 27, 2004, in connection with the purchase accounting for goClick, we recorded net deferred assets of approximately \$11,000 relating to the difference in the book versus tax basis of its assets and liabilities. The \$9.4 million of goodwill and \$3.3 million of intangible assets relating to the goClick acquisition are being deducted for tax purposes over a 15 year period.

During the period from January 1, 2003 through February 28, 2003 and in the nine months ended September 30, 2004, as a result of tax deductions from stock option exercises, Enhance Interactive and we recognized tax-effected benefits of approximately \$231,000 and \$180,000 respectively, which were recorded as credits to additional paid in capital.

*Accretion to Redemption Value of Redeemable Convertible Preferred Stock.* The accretion to redemption value of preferred stock decreased 54%, from \$912,000 in the nine months ended September 30, 2003 to \$420,000 in the same period in 2004. The accretion to the redemption value recorded during these periods is based upon 6,724,063 shares of Series A redeemable convertible preferred stock outstanding as of April 5, 2004 with a dividend rate of 8% per annum. All 6,724,063 shares of Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock upon the closing of the initial public offering on April 5, 2004.

*Net Income (Loss) Applicable to Common Stockholders.* The net loss applicable to common stockholders decreased 12%, from \$2.0 million in the nine months ended September 30, 2003 period to \$1.8 million in the same period in 2004. The decrease was primarily attributable to revenue increasing at a faster rate than sales and marketing, product development and general and administrative expenses, a decrease in accretion to redemption value of the Series A redeemable convertible preferred stock of \$491,000, a decrease in stock-based compensation of \$905,000, partially offset by an increase in service costs as a percentage of revenue, an increase in amortization of intangible assets of \$1.4 million, an increase in acquisition-related retention consideration of \$375,000 and an increase in facility relocation costs of \$200,000.

#### *Operating Income before Amortization*

Our management believes that certain non-GAAP measures, which are calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles (GAAP), are helpful, when presented in conjunction with comparable GAAP measures. The non-GAAP measures are not meant to replace or supersede the GAAP measures, but rather to supplement the GAAP information

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and to present to the readers of the financial statements the same information that management considers in assessing our results of operations and performance.

When presenting non-GAAP measures we will present a reconciliation of the most directly comparable GAAP measure. These non-GAAP measures are consistent with how management views our results of operations in assessing performance.

We report operating income before amortization (OIBA) that is a supplemental measure to GAAP. OIBA represents income (loss) from operations before: (1) stock-based compensation expense; and (2) amortization of intangible assets. It is one of the primary metrics by which we evaluate the performance of our business.

Additionally, management uses adjusted OIBA which excludes both: (1) the acquisition-related retention consideration, as we view this as part of the earn-out incentives related to our acquisition of Enhance Interactive; and (2) a facility relocation expense. Both of these items are viewed as non-recurring in nature. The Enhance Interactive earn-out consideration is recorded for its respective calendar year, and the facility relocation expense was recorded in the nine months ended September 30, 2004.

We refer to adjusted OIBA to facilitate accurate comparisons to our historical operating results, in making operating decisions, for internal budget planning, and in some cases to form the basis upon which management is evaluated. Management believes that investors should have access to, and we are obligated to provide, the same set of tools that we use in analyzing our results. These non-GAAP measures should be considered in addition to results prepared in accordance with GAAP, and should not be considered in isolation, as a substitute for or superior to GAAP results. We believe these measures are useful to investors because they represent our consolidated operating results, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash and non-recurring expenses.

OIBA and adjusted OIBA have certain limitations in that they do not take into account the impact to our statement of operations of certain expenses, including non-cash stock-based compensation associated with our employees, acquisition-related accounting and facility relocation amounts. We endeavor to address the limitations of these non-GAAP measures presented by providing the comparable GAAP measure with equal or greater prominence, GAAP financial statements and detailed descriptions of the reconciling items and adjustments, including quantifying such items, to derive the non-GAAP measure.

The following are the non-cash expenses that are excluded from our non-GAAP measures:

- stock-based compensation consists of restricted stock and options expense, which relates mostly to restricted stock and options issued in connection with acquisitions. We view this expense as part of transaction costs which are not paid in cash. Stock-based compensation also includes the expense associated with certain employee stock options where on the date of grant the fair value of the underlying stock exceeded the exercise price.
- amortization of intangible assets is a non-cash expense relating primarily to acquisitions. At the time of an acquisition, the intangible assets of the acquired company, such as distribution partner relationships and merchant advertiser customer relationships are valued and amortized over their estimated lives. While it is likely that we will have significant intangible amortization expense as we continue to acquire companies, we believe that since intangibles represent costs incurred by the acquired company to build value prior to the acquisition, they were part of transaction costs and will not be replaced with cash costs when the intangibles are fully amortized.

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The following is a reconciliation of income (loss) from operations and net income (loss) applicable to common stockholders to the non-GAAP measure of operating income before amortization, also referred to as OIBA, for the year ended December 31, 2002, the period of January 1, 2003 to February 28, 2003 and the period of January 17, 2003 (inception) to September 30, 2003, the period from January 17, 2003 (inception) to December 31, 2003 and for the nine months ended September 30, 2004.

	Predecessor Periods		Successor Periods		
	Year ended December 31, 2002	Period from January 1 to February 28, 2003	Period from January 17, (inception) to December 31, 2003	Period from January 17, (inception) to September 30, 2003	Nine months ended September 30, 2004
Operating income before amortization	\$ 126,543	\$ 594,053	\$ 1,820,795	\$ 1,371,829	\$ 2,517,971
Stock-based compensation	(364,693)	(38,981)	(2,125,110)	(1,587,476)	(721,403)
Amortization of intangible assets			(3,023,408)	(2,028,244)	(3,473,976)
Income (loss) from operations	(238,150)	555,072	(3,327,723)	(2,243,891)	(1,677,408)
Other income:					
Interest income	5,491	1,529	45,874	33,502	163,808
Interest expense					(3,728)
Adjustment to fair value of redemption obligation			25,500		55,250
Other			2,685		3,644
Total other income	5,491	1,529	74,059	33,502	218,974
Income (loss) before provision for income taxes	(232,659)	556,601	(3,253,664)	(2,210,389)	(1,458,434)
Income tax expense (benefit)	(142,876)	224,082	(1,084,312)	(783,231)	(118,016)
Net income (loss)	(89,783)	332,519	(2,169,352)	(1,427,158)	(1,340,418)
Accretion to redemption value of redeemable convertible preferred stock			1,318,885	911,620	420,430
Net income (loss) applicable to common stockholders	\$ (89,783)	\$ 332,519	\$ (3,488,237)	\$ (2,338,778)	\$ (1,760,848)

OIBA increased from \$127,000 in the 2002 period to \$2.4 million in the 2003 period. The increase was primarily attributable to increased operating activity that resulted in an increase in revenue of \$12.9 million offset by an increase in operating expenses of \$10.6 million, excluding stock-based compensation expense and amortization of intangible assets. OIBA increased in the nine months ended September 30, 2004 by \$552,000, or 28%, as compared to the same period in 2003. This increase was primarily attributable to revenue increasing at a faster rate than sales and marketing, product development and general and administrative expenses, partially offset by an increase in service costs as a percentage of revenue, an increase in acquisition-related retention consideration of \$375,000 and an increase in facility relocation costs of \$200,000.



## Quarterly Results of Operations

The following tables set forth our unaudited quarterly results of operations data for the eight most recent quarters and periods ended September 30, 2004, as well as such data expressed as a percentage of our revenues for the periods presented. The information in the tables below should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this prospectus. We have prepared this information on the same basis as the consolidated financial statements and the information includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for the quarters or other periods presented. Our quarterly operating results have varied substantially in the past and may vary substantially in the future. You should not draw any conclusions about our future results from the results of operations for any particular quarter or period presented.

	Predecessor Periods			Successor Periods					
	Quarter ended	Period from Jan 1 to Feb 28, 2003	Period from Jan 17, (inception) to March 31, 2003	Quarter ended					
				June 30, 2003	Sept 30, 2003	Dec 31, 2003	March 31, 2004	June 30, 2004	Sept 30, 2004
Dec 31, 2002	2003	2003	2003	2003	2003	2003	2004	2004	2004
<b>Consolidated Statement of Operations Data:</b>									
Revenue	\$ 3,642,928	\$ 3,071,055	\$ 1,715,933	\$ 5,356,286	\$ 5,359,274	\$ 7,460,665	\$ 7,601,911	\$ 8,865,178	\$ 12,215,835
Expenses:									
Service costs <sup>(1)</sup>	2,170,479	1,732,813	883,280	2,955,535	2,967,206	4,486,049	4,779,575	5,743,815	7,619,496
Sales and marketing <sup>(1)</sup>	684,853	365,043	214,615	654,182	723,753	868,133	1,009,972	1,030,710	1,156,314
Product development <sup>(1)</sup>	322,543	144,479	104,947	354,927	384,248	447,300	505,535	528,306	602,478
General and administrative <sup>(1)</sup>	357,837	234,667	426,919	729,856	659,177	927,967	694,748	846,680	1,072,505
Acquisition-related retention consideration <sup>(2)</sup>						283,269	132,936	122,724	119,198
Facility relocation							230,459		(30,499)
Stock-based compensation <sup>(3)</sup>	2,421	38,981	710,991	550,078	326,407	537,634	360,764	235,234	125,405
Amortization of intangible assets <sup>(4)</sup>			290,087	869,588	869,588	994,145	1,034,868	1,034,643	1,404,464
<b>Total operating expenses</b>	<b>3,538,133</b>	<b>2,515,983</b>	<b>2,630,839</b>	<b>6,114,166</b>	<b>5,930,379</b>	<b>8,544,497</b>	<b>8,748,857</b>	<b>9,542,112</b>	<b>12,069,361</b>
Income (loss) from operations	104,795	555,072	(914,906)	(757,880)	(571,105)	(1,083,832)	(1,146,946)	(676,934)	146,474
Other income:									
Interest income	2,967	1,529	3,092	13,479	16,931	12,372	11,016	70,329	82,462
Interest expense							(325)	(1,488)	(1,915)
Adjustment to fair value of redemption obligation						25,500	55,250		
Other						2,685	3,644		
<b>Total other income</b>	<b>2,967</b>	<b>1,529</b>	<b>3,092</b>	<b>13,479</b>	<b>16,931</b>	<b>40,557</b>	<b>69,585</b>	<b>68,841</b>	<b>80,547</b>
Income (loss) before provision for income taxes	107,762	556,601	(911,814)	(744,401)	(554,174)	(1,043,275)	(1,077,361)	(608,093)	227,021
Income tax expense (benefit)	47,841	224,082	(323,092)	(263,771)	(196,368)	(301,081)	(53,700)	(147,103)	82,787
<b>Net income (loss)</b>	<b>59,921</b>	<b>332,519</b>	<b>(588,722)</b>	<b>(480,630)</b>	<b>(357,806)</b>	<b>(742,194)</b>	<b>(1,023,661)</b>	<b>(460,990)</b>	<b>144,234</b>
Accretion to redemption value of redeemable convertible preferred stock			119,081	385,274	407,265	407,265	402,679	17,751	
<b>Net income (loss) applicable to common stockholders</b>	<b>\$ 59,921</b>	<b>\$ 332,519</b>	<b>\$ (707,803)</b>	<b>\$ (865,904)</b>	<b>\$ (765,071)</b>	<b>\$ (1,149,459)</b>	<b>\$ (1,426,340)</b>	<b>\$ (478,741)</b>	<b>\$ 144,234</b>

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**Other Financial Data:**

Operating income before amortization (OIBA) \$ 107,216 \$ 594,053 \$ 86,172 \$ 661,786 \$ 624,890 \$ 447,947 \$ 248,686 \$ 592,943 \$ 1,676,343

(1) Excludes acquisition-related retention consideration, stock-based compensation and amortization of intangible assets

(2) Components of acquisition-related retention consideration:

Service costs	\$	\$	\$	\$	\$	\$ 33,723	\$ 15,826	\$ 14,604	\$ 14,185
Sales and marketing						96,262	45,175	41,726	40,503
Product development						104,233	48,916	45,162	43,865
General and administrative						49,051	23,019	21,232	20,645

(3) Components of stock-based compensation:

Service costs	\$	285	\$	190	\$		\$	9,776	\$	4,050	\$	2,250	\$	2,250
Sales and marketing		1,073		715		128,993		99,861		87,720		105,297		67,546
Product development		315		37,710		69,769		95,108		38,348		37,855		21,902
General and administrative		748		366		512,229		355,109		200,339		384,706		267,266

(4) Components of amortization of intangible assets:

Service costs	\$	\$	\$	215,087	\$	644,588	\$	644,588	\$	712,694	\$	734,868	\$	734,643	\$	978,389
Sales and marketing				29,167		87,500		87,500		143,951		162,500		162,500		207,527
Product development																
General and administrative				45,833		137,500		137,500		137,500		137,500		137,500		218,548

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	Predecessor Periods		Successor Periods					
	Quarter ended Dec 31, 2002	Period from Jan 1 to Feb 28, 2003	Period from Jan 17, (inception) to March 31, 2003	Quarter ended				
				June 30, 2003	Sept 30, 2003	Dec 31, 2003	March 31, 2004	June 30, 2004
<b>Consolidated Statement of Operations Data:</b>								
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0