

HouseValues, Inc.
Form 10-Q
August 02, 2006
Table of Contents

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

FORM 10-Q

(Mark One)

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

OR

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

HouseValues, Inc.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of

incorporation or organization)

11332 NE 122nd Way, Kirkland, WA 98034

(Address of principal executive offices, including zip code)

(425) 952-5500

(Registrant's telephone number, including area code)

91-1982679
(IRS Employer

Identification No.)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of July 21, 2006, there were outstanding 26,049,308 shares of the registrant's common stock, \$0.001 par value, which is the only class of common stock of the registrant.

Table of Contents

HOUSEVALUES, INC.

FORM 10-Q

Index

| | Page |
|--|-------------|
| PART I. FINANCIAL INFORMATION | |
| Item 1. Condensed Consolidated Financial Statements (unaudited) | |
| <u>Condensed Consolidated Statements of Income for the three and six months ended June 30, 2006 and 2005</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the three and six months ended June 30, 2006 and 2005</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 19 |
| Item 4. <u>Controls and Procedures</u> | 19 |
| PART II. OTHER INFORMATION | |
| Item 1. <u>Legal Proceedings</u> | 20 |
| Item 1A. <u>Risk Factors</u> | 20 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 30 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 30 |
| Item 6. <u>Exhibits</u> | 30 |
| <u>SIGNATURE</u> | 31 |

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--|-------------|--------------------------------------|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | \$ 25,866 | \$ 20,577 | \$ 52,737 | \$ 38,196 |
| Expenses: | | | | |
| Sales and marketing (1) | 16,121 | 10,338 | 32,396 | 19,026 |
| Technology and product development (1) | 3,670 | 1,739 | 7,281 | 3,135 |
| General and administrative (1) | 3,691 | 3,107 | 7,441 | 5,946 |
| Depreciation and amortization of property and equipment (2) | 1,116 | 402 | 2,130 | 756 |
| Amortization of intangible assets | 404 | 151 | 805 | 303 |
| Total expenses | 25,002 | 15,737 | 50,053 | 29,166 |
| Income from operations | 864 | 4,840 | 2,684 | 9,030 |
| Interest income, net | 690 | 486 | 1,294 | 804 |
| Income before income tax (benefit)/expense | 1,554 | 5,326 | 3,978 | 9,834 |
| Income tax (benefit)/expense | (340) | 1,618 | 314 | 3,196 |
| Net income | \$ 1,894 | \$ 3,708 | \$ 3,664 | \$ 6,638 |
| Net income per share: | | | | |
| Basic | \$ 0.07 | \$ 0.15 | \$ 0.14 | \$ 0.26 |
| Diluted | \$ 0.07 | \$ 0.14 | \$ 0.13 | \$ 0.24 |

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

| | 2006 | 2005 | 2006 | 2005 |
|------------------------------------|-------------|-------------|-------------|-------------|
| Sales and marketing | \$ 212 | \$ 62 | \$ 580 | \$ 128 |
| Technology and product development | 239 | 22 | 402 | 79 |
| General and administrative | 645 | 174 | 1,166 | 348 |
| | \$ 1,096 | \$ 258 | \$ 2,148 | \$ 555 |

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

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

| | 2006 | 2005 | 2006 | 2005 |
|------------------------------------|----------|--------|----------|--------|
| Technology and product development | \$ 598 | \$ 118 | \$ 1,120 | \$ 231 |
| General and administrative | 518 | 284 | 1,010 | 525 |
| | \$ 1,116 | \$ 402 | \$ 2,130 | \$ 756 |

See accompanying notes to condensed consolidated financial statements.

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

| | June 30, 2006 | December 31, 2005 |
|---|--------------------------|------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 56,837 | \$ 59,234 |
| Short-term investments | 30,575 | 25,640 |
| Accounts receivable, net of allowance of \$177 and \$242 | 627 | 577 |
| Prepaid expenses and other assets | 1,557 | 1,700 |
| Deferred income taxes | 1,208 | 258 |
| Prepaid income taxes | 1,056 | 997 |
| Other current assets | 71 | 579 |
| Total current assets | 91,931 | 88,985 |
| Property and equipment, net of accumulated depreciation of \$5,819 and \$3,689 | 12,548 | 11,118 |
| Goodwill | 6,846 | 6,227 |
| Intangible assets, net of accumulated amortization of \$2,807 and \$2,003 | 4,058 | 4,853 |
| Other noncurrent assets | 409 | 408 |
| Total assets | \$ 115,792 | \$ 111,591 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,568 | \$ 1,030 |
| Accrued compensation and benefits | 3,325 | 4,236 |
| Accrued expenses and other current liabilities | 4,258 | 6,529 |
| Deferred rent, current portion | 289 | 289 |
| Deferred revenue | 1,593 | 1,694 |
| Total current liabilities | 11,033 | 13,778 |
| Deferred income taxes | 973 | 726 |
| Deferred rent, less current portion | 1,264 | 1,423 |
| Note payable | 1,676 | 1,600 |
| Total liabilities | 14,946 | 17,527 |
| Shareholders' equity: | | |
| Common stock, par value \$0.001 per share, stated at amounts paid in; authorized 120,000,000 shares; issued and outstanding 26,046,334 and 25,783,980 shares at June 30, 2006 and December 31, 2005, respectively | 71,606 | 71,385 |
| Deferred stock-based compensation | | (2,897) |
| Retained earnings | 29,240 | 25,576 |
| Total shareholders' equity | 100,846 | 94,064 |
| Total liabilities and shareholders' equity | \$ 115,792 | \$ 111,591 |

See accompanying notes to condensed consolidated financial statements.

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

| | Six months ended June 30, | |
|---|----------------------------------|-------------|
| | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net income | \$ 3,664 | \$ 6,638 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 2,130 | 756 |
| Amortization of intangible assets | 805 | 303 |
| Stock-based compensation | 2,148 | 555 |
| Deferred income tax benefit | (703) | (513) |
| Excess tax benefit from exercises of stock options | | 1,107 |
| Changes in certain assets and liabilities | | |
| Accounts receivable | (50) | (309) |
| Prepaid expenses and other assets | 310 | 81 |
| Prepaid income taxes | 3 | (1,212) |
| Other current assets | 508 | 1,067 |
| Accounts payable | (231) | 180 |
| Accrued compensation and benefits | (911) | 507 |
| Accrued expenses and other current liabilities | 1,131 | 1,048 |
| Deferred rent | (159) | 110 |
| Deferred revenue | (101) | 322 |
| Income taxes payable and other | 76 | (103) |
| Net cash provided by operating activities | 8,620 | 10,537 |
| Cash flows from investing activities: | | |
| Purchases of short-term investments | (5,000) | (10,799) |
| Sales of short-term investments | 65 | 4,300 |
| Purchases of property and equipment | (5,619) | (3,402) |
| Additions to intangible assets and other | (48) | (199) |
| Earn-out payments related to the SOAR Solutions acquisition | (1,287) | (381) |
| Net cash used in investing activities | (11,889) | (10,481) |
| Cash flows from financing activities: | | |
| Proceeds from exercises of stock options and warrants | 567 | 654 |
| Excess tax benefit from exercises of stock options | 305 | |
| Issuance costs related to the sale of common stock | | (614) |
| Net cash provided by financing activities | 872 | 40 |
| Net (decrease) increase in cash and cash equivalents | (2,397) | 96 |
| Cash and cash equivalents at beginning of period | 59,234 | 57,562 |
| Cash and cash equivalents at end of period | \$ 56,837 | \$ 57,658 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

HouseValues, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands except per share amounts)

(unaudited)

Note 1: Summary of Significant Accounting Policies

Nature of Operations

Founded in 1999, HouseValues Inc. provides consumers and real estate professionals with the information and tools they need for success throughout the home buying and selling process. Our flagship consumer products include HomePages.com, an Internet web site that combines aerial maps, in-depth neighborhood information and nationwide home listings in one integrated web site; TheLoanPage.com, a service that provides current and prospective home owners with competitive mortgage and refinance quotes from leading lenders; HouseValues.com, a service that provides home sellers with market valuations of their current home; and JustListed.com, a service that alerts home buyers as soon as new homes hit the market that meet their criteria.

Basis of Presentation

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

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

Use of Estimates

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

Reclassifications

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

Summary of significant accounting policies

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

Stock-based Compensation

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

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

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

reclassified to our common stock account.

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

Table of Contents

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

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

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

Recent Accounting Pronouncements

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

Note 2: Acquisitions**The Loan Page**

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

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

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

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

Table of Contents

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

| | Three months ended June 30, 2005 | Six months ended June 30, 2005 |
|------------------------------|---|---|
| Revenues | \$ 22,079 | \$ 40,762 |
| Net income | \$ 3,159 | \$ 5,752 |
| Net income per share basic | \$ 0.13 | \$ 0.23 |
| Net income per share diluted | \$ 0.12 | \$ 0.21 |

Soar Solutions

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

Note 3: Earnings per share

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|------------------------------------|-------------|----------------------------------|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| Calculation of basic earnings per share: | | | | |
| Net income | \$ 1,894 | \$ 3,708 | \$ 3,664 | \$ 6,638 |
| Weighted average common shares outstanding | 25,929 | 25,258 | 25,870 | 25,142 |
| Dilutive effect of stock options | 1,343 | 2,144 | 1,501 | 2,183 |
| Diluted Shares | 27,272 | 27,402 | 27,371 | 27,325 |
| Basic earnings per share | \$ 0.07 | \$ 0.15 | \$ 0.14 | \$ 0.26 |
| Diluted earnings per share | \$ 0.07 | \$ 0.14 | \$ 0.13 | \$ 0.24 |
| Antidilutive stock options | 1,910 | 361 | 1,860 | 361 |

Note 4: Income Taxes

We recorded a tax benefit of \$340 for the three months ended June 30, 2006 due to the change in our estimated annual effective rate to approximately 8% from our estimate of 27% last quarter. Our effective tax rate was decreased due to our revised estimate of lower annual operating earnings relative to our tax-exempt interest income. Tax expense for the six months ended June 30, 2006 was \$314, or approximately 8% of pre-tax income. This compares to effective rates of 30% and 33% for the three and six month periods ended June 30, 2005.

Table of Contents**Note 5: Product line revenues**

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

| | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------|-----------------------------|-----------|---------------------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Real estate product revenues | \$ 22,391 | \$ 19,145 | \$ 45,627 | \$ 36,315 |
| Mortgage product revenues | 3,475 | 1,432 | 7,110 | 1,881 |
| Total revenue | \$ 25,866 | \$ 20,577 | \$ 52,737 | \$ 38,196 |

Note 6: Stock-based compensation plans

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

Determining Fair Value under FAS 123R

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

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

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

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

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

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|---------|---------------------------|---------|
| | 2006 | 2005 | 2006 | 2005 |
| Expected life (in years) | 3.0 | 3.0 | 3.0 | 3.5 |
| Weighted average expected volatility | 90% | 90% | 90% | 95% |
| Weighted average risk-free interest rate | 4.99% | 3.71% | 4.68% | 4.01% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Weighted average fair value | \$ 5.26 | \$ 8.18 | \$ 7.55 | \$ 8.72 |

Table of Contents**Stock-based Compensation Under FAS 123R**

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

| | Three months ended | Six months ended |
|---|--------------------|------------------|
| | June 30, 2006 | June 30, 2006 |
| Total cost of share-based payment plans | \$ 1,144 | \$ 2,245 |
| Amounts capitalized in internally developed software | (48) | (97) |
| Amounts charged against income, before income tax benefit | \$ 1,096 | \$ 2,148 |
| Amount of related income tax benefit recognized in income | \$ 84 | \$ 162 |
| Amounts recognized in income for amounts previously capitalized in fixed assets | \$ 4 | \$ 5 |

As of June 30, 2006, we had \$14,613 of unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans. We expect to recognize this cost over a weighted average period of 1.54 years.

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

| | As reported following | | If reported following | |
|--|---|-----------------------------------|---|-----------------------------------|
| | FAS 123R | | APB 25 | |
| | Three months ended June 30, 2006 | Six months ended June 30, 2006 | Three months ended June 30, 2006 | Six months ended June 30, 2006 |
| Condensed consolidated statement of operations: | | | | |
| Income before income tax expense or benefit | \$ 1,554 | \$ 3,978 | \$ 2,370 | \$ 5,664 |
| Net income | \$ 1,894 | \$ 3,664 | \$ 2,647 | \$ 5,220 |
| Net income per share | | | | |
| Basic | \$ 0.07 | \$ 0.14 | \$ 0.10 | \$ 0.20 |
| Diluted | \$ 0.07 | \$ 0.13 | \$ 0.10 | \$ 0.19 |
| Condensed consolidated statement of cash flows: | | | | |
| Net cash provided by operating activities | | \$ 8,620 | | \$ 8,925 |
| Net cash provided by financing activities | | \$ 872 | | \$ 567 |

Stock Option Activity

At June 30, 2006, we had two stock option plans. Additional information regarding these plans is disclosed in our 2005 Annual Report on Form 10-K. As of June 30, 2006, we have reserved an additional 1.7 million shares for future issuance under our stock option plans. We issue new shares for option exercises.

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

| Options | Weighted Average Exercise Price | Weighted Average Fair Value | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|---------|--|--------------------------------------|---|---------------------------------|
|---------|--|--------------------------------------|---|---------------------------------|

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

| | | | | | |
|----------------------------------|-----------|---------|---------|-----------|----------|
| Outstanding at December 31, 2005 | 4,102,102 | \$ 6.93 | \$ 4.64 | | |
| Options granted | 254,400 | 12.70 | 7.57 | | |
| Options exercised | (262,354) | 2.16 | 0.67 | | |
| Options forfeited | (315,318) | 10.37 | 6.39 | | |
| Options expired | (4,499) | 14.09 | 10.50 | | |
| Outstanding at June 30, 2006 | 3,774,331 | \$ 7.35 | \$ 4.96 | 8.0 years | \$ 9,551 |
| Exercisable at June 30, 2006 | 1,642,232 | \$ 3.39 | \$ 2.28 | 6.8 years | \$ 6,937 |

Table of Contents

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

| | Three months ended June 30, Six months ended June 30, | | | |
|--------------------------------------|---|----------|----------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Intrinsic value of options exercised | \$ 1,214 | \$ 4,942 | \$ 1,846 | \$ 6,796 |
| Fair value of options vested | \$ 864 | \$ 468 | \$ 1,729 | \$ 744 |
| Fair value of options forfeited | \$ 777 | \$ 578 | \$ 2,016 | \$ 935 |

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

| | Three months ended June 30, 2006 | | Six months ended June 30, 2006 | |
|-----------------------------------|----------------------------------|--|--------------------------------|--|
| | Option Activity | Weighted Average Grant Date Fair Value | Option Activity | Weighted Average Grant Date Fair Value |
| Non-vested at beginning of period | 2,376,915 | \$ 6.82 | 2,644,859 | \$ 6.35 |
| Options granted | 75,600 | 5.35 | 254,400 | 7.57 |
| Options canceled | (100,454) | 7.73 | (315,318) | 6.39 |
| Options vested | (219,962) | 3.93 | (451,842) | 3.83 |
| Non-vested at end of period | 2,132,099 | \$ 7.03 | 2,132,099 | \$ 7.03 |

Pro Forma Information under FAS 123 and APB 25

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|----------|---------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Net income, as reported | \$ 1,894 | \$ 3,708 | \$ 3,664 | \$ 6,638 |
| Add: stock-based compensation included in net income, net of tax | 1,012 | 189 | 1,986 | 400 |
| Deduct: total stock-based compensation determined under fair value based method for all awards, net of tax | (1,012) | (372) | (1,986) | (686) |
| Net income (pro forma for 2005) | \$ 1,894 | \$ 3,525 | \$ 3,664 | \$ 6,352 |
| Basic net income per share: | | | | |
| As reported | \$ 0.07 | \$ 0.15 | \$ 0.14 | \$ 0.26 |
| Pro forma (for 2005) | | \$ 0.14 | | \$ 0.25 |
| Diluted net income loss per share: | | | | |
| As reported | \$ 0.07 | \$ 0.14 | \$ 0.13 | \$ 0.24 |
| Pro forma (for 2005) | | \$ 0.13 | | \$ 0.24 |

Note 7: B&O Tax Audit Settlement

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

Table of Contents

Note 8: Supplemental Disclosure of Cash Flow Information

| | Six months ended | |
|---|------------------|----------|
| | June 30, | |
| | 2006 | 2005 |
| Cash paid during the period for income taxes, net of refunds received | \$ 708 | \$ 3,917 |
| Noncash investing and financing activities: | | |
| Accrued earn-out payments in connection with acquisitions | \$ | \$ 486 |
| Accrued invoices for property and equipment | \$ 292 | \$ 553 |

Table of Contents

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

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

Overview

Revenue for the second quarter of 2006 was \$25.9 million, an increase of 26% compared to the second quarter of 2005 and a decline of 4% compared to the first quarter of 2006. Net income decreased 49% to \$1.9 million, when compared to the same quarter last year as we continue to invest in building our business. While our operating earnings declined 52% when compared to the first quarter of 2006 primarily due to lower revenue, net income increased 7% as a result of an adjustment to our annual effective income tax rate.

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

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

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

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

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

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

Table of Contents

For the six months ended June 30, 2006, revenue from our mortgage products represents 13% of our revenues compared to 5% in 2005.

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

Results of Operations

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

Revenues

| | Three months ended June 30, | | Six months ended June 30, | |
|----------------------|-----------------------------|------------------|---------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Real Estate Revenues | \$ 22,391 | \$ 19,145 | \$ 45,627 | \$ 36,315 |
| Mortgage Revenues | 3,475 | 1,432 | 7,110 | 1,881 |
| Revenues | \$ 25,866 | \$ 20,577 | \$ 52,737 | \$ 38,196 |

Revenues for the second quarter of 2006 increased 26% over the same quarter in 2005 and 38% for the year-to-date period as compared to 2005 due to the growth of our real estate business and the 2005 launch of our mortgage business. Our real estate revenues increased 26% year over year due to the growth of our JustListed and HouseValues products and the 2006 addition of our HomePages service. Average core real estate customer count increased 21% while our average real estate revenue per customer decreased slightly.

Revenue in the second quarter of 2006 decreased 4% from the first quarter of 2006. The majority of the decline was due to a decrease in our real estate revenues. We experienced a 6% decrease in average real estate revenue per customer partially offset by a 3% increase in average real estate core customers for the period. Average revenue per real estate customer declined as we have shifted our sales focus to more under-penetrated areas, some of which are lower-priced markets. Additionally, we believe agents are being more cautious with their advertising spend due to slowing in the real estate market, resulting in more price discounting that also impacted our average revenue per customer. More information about the sequential change in real estate revenue and customers is included in the Key Operational Metrics Real Estate Products section of Management's Discussion and Analysis.

Given current market conditions, we expect quarterly revenue to decrease slightly in the rest of 2006, moderated by additional revenue from potential new service offerings later this year.

Sales and Marketing

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------|------------------|---------------------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Sales and marketing expense before stock-based compensation | \$ 15,909 | \$ 10,276 | \$ 31,816 | \$ 18,898 |
| Stock-based compensation | 212 | 62 | 580 | 128 |
| Total sales and marketing expense | \$ 16,121 | \$ 10,338 | \$ 32,396 | \$ 19,026 |

As a percentage of revenue:

| | | | | |
|---|-----|-----|-----|-----|
| Sales and marketing expense before stock-based compensation | 61% | 50% | 60% | 50% |
| Stock-based compensation | 1% | | 1% | |

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

| | | | | |
|-----------------------------------|-----|-----|-----|-----|
| Total sales and marketing expense | 62% | 50% | 61% | 50% |
|-----------------------------------|-----|-----|-----|-----|

Sales and marketing expense increased in total and as a percentage of revenue primarily due to the increase in lead generation costs resulting from greater customer demand and increased cost of leads and the increase in our sales headcount,

Table of Contents

a portion of which related to our investment in new business initiatives. These media costs, as a percentage of revenue for HouseValues and Just Listed, were higher than the record low levels seen in the first half of 2005, and comparable to levels seen in 2004. Sales and marketing expenses related to HomePages and The Loan Page exceeded their revenue contribution in 2006, reflecting new advertising to expand consumer awareness and the hiring of personnel to drive these business initiatives.

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

Technology and Product Development

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|-----------------|---------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Technology and product development expense before stock-based compensation | \$ 3,431 | \$ 1,717 | \$ 6,879 | \$ 3,056 |
| Stock-based compensation | 239 | 22 | 402 | 79 |
| Total technology and product development expense | \$ 3,670 | \$ 1,739 | \$ 7,281 | \$ 3,135 |
| As a percentage of revenue: | | | | |
| Technology and product development expense before stock-based compensation | 13% | 8% | 13% | 8% |
| Stock-based compensation | 1% | | 1% | |
| Total technology and product development expense | 14% | 8% | 14% | 8% |

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

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

General and Administrative

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|-----------------|---------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| General and administrative expense before stock-based compensation | \$ 3,046 | \$ 2,933 | \$ 6,275 | \$ 5,598 |
| Stock-based compensation | 645 | 174 | 1,166 | 348 |
| Total general and administrative expense | \$ 3,691 | \$ 3,107 | \$ 7,441 | \$ 5,946 |
| As a percentage of revenue: | | | | |
| General and administrative expense before stock-based compensation | 12% | 14% | 12% | 15% |
| Stock-based compensation | 2% | 1% | 2% | 1% |
| Total general and administrative expense | 14% | 15% | 14% | 16% |

General and administrative expenses increased in total dollars but decreased as a percentage of revenues for the quarter and year-to-date periods ended June 30, 2006 when compared to the same periods last year, primarily due to several factors:

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

increased salaries and related expenses, including stock-based compensation, for additional staffing to support the growth in the business, as well as our operations as a public company;

increased rent and facilities costs, primarily due to the opening of our Yakima location; and

increased credit card fees directly related to the increase in our revenues.

These increases were partially offset by decreases to our state and local tax expense. In December 2005, we reached an agreement with the Washington State Department of Revenue to settle a business and occupation tax audit covering the period from January 2001 through September 2005 for a total of \$675. Through September 2005, we had accrued \$2,468 for

Table of Contents

the estimated cost of the assessment, which was our best estimate of our ultimate liability based on the preliminary assessment and subsequent negotiations with the Department of Revenue. As a result, in 2005, we reduced our accrual to the settlement amount and recorded \$1.8 million as a reduction of general and administrative expenses. Additionally we have adjusted our accrual percentage going forward.

For the third quarter of 2006, we expect general and administrative expenses to increase slightly in total dollars and to increase slightly as a percentage of revenue due to anticipated severance costs of terminated employees.

Depreciation and Amortization of Property and Equipment

Depreciation and amortization of property and equipment increased year-over-year primarily due to additional depreciation expense on capitalized software development and on workstations and equipment purchased to accommodate our increased headcount.

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

Amortization of Intangible Assets

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

Interest Income

Interest income increased for the quarter and year to date periods ended June 30, 2006, when compared to the same periods in 2005 due to larger cash and investment balances in 2006 and as well as increased rates of return on investments. At June 30, 2006, we held \$87.4 million in cash, cash equivalents and short-term investments, compared to \$81.5 million at June 30, 2005. Cash, cash equivalents and short-term investments increased primarily due to cash generated from operations, net of investments in capital assets.

Income Taxes

Income tax expense for 2006 decreased compared to last year as a result of lower pretax income and a lower estimated effective tax rate. We recorded a tax benefit for the second quarter of 2006 due to the change in our estimated annual effective rate to approximately 8% from our estimate of 27% last quarter. Our effective tax rate was decreased due to our revised estimate of lower annual operating earnings relative to our tax-exempt interest income. Tax expense for the year-to-date period ended June 30, 2006 was \$314, or approximately 8% of pre-tax income, reflecting our revised estimated effective tax rate. This compares to effective rates of 30% and 33% for the quarter and year-to-date periods ended June 30, 2005.

Because tax-exempt interest income has become a larger share of operating income, changes to forecasted operating income could have a significant impact on our effective tax rate and the related tax expense for the remainder of 2006.

Critical Accounting Policies and Estimates

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

Table of Contents**Quarterly Consolidated Statements of Income and Operational Data**

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

| | Mar. 31, 2005 | June 30, 2005 | Sept. 30, 2005 | Dec. 31, 2005 | Mar. 31, 2006 | June 30, 2006 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| | (in thousands) | | | | | |
| Consolidated Statements of Income Data: | | | | | | |
| Revenues | \$ 17,619 | \$ 20,577 | \$ 23,337 | \$ 25,177 | \$ 26,871 | \$ 25,866 |
| Expenses: | | | | | | |
| Sales and marketing | 8,688 | 10,338 | 11,556 | 13,669 | 16,275 | 16,121 |
| Technology and product development | 1,396 | 1,739 | 1,823 | 2,692 | 3,611 | 3,670 |
| General and administrative | 2,839 | 3,107 | 3,375 | 2,465 | 3,750 | 3,691 |
| Depreciation and amortization of property and equipment | 354 | 402 | 506 | 629 | 1,014 | 1,116 |
| Amortization of intangible assets | 152 | 151 | 151 | 322 | 401 | 404 |
| Total expenses | 13,429 | 15,737 | 17,411 | 19,777 | 25,051 | 25,002 |
| Income from operations | 4,190 | 4,840 | 5,926 | 5,400 | 1,820 | 864 |
| Interest income | 318 | 486 | 491 | 579 | 604 | 690 |
| Income before income tax expense/(benefit) | 4,508 | 5,326 | 6,417 | 5,979 | 2,424 | 1,554 |
| Income tax expense/(benefit) | 1,578 | 1,618 | 2,086 | 1,965 | 654 | (340) |
| Net income | \$ 2,930 | \$ 3,708 | \$ 4,331 | \$ 4,014 | \$ 1,770 | \$ 1,894 |

| | | | | | | |
|---|------------|------------|------------|------------|-----------|-----------|
| Consolidated Statements of Income Data as a Percentage of Revenue: | | | | | | |
| Revenues | 100% | 100% | 100% | 100% | 100% | 100% |
| Expenses: | | | | | | |
| Sales and marketing | 49 | 50 | 49 | 54 | 61 | 63 |
| Technology and product development | 8 | 8 | 8 | 11 | 13 | 14 |
| General and administrative | 16 | 15 | 14 | 10 | 14 | 14 |
| Depreciation and amortization of property and equipment | 2 | 2 | 2 | 2 | 4 | 4 |
| Amortization of intangible assets | 1 | 1 | 1 | 1 | 1 | 2 |
| Total expenses | 76 | 76 | 74 | 78 | 93 | 97 |
| Income from operations | 24 | 24 | 26 | 22 | 7 | 3 |
| Interest income | 2 | 2 | 2 | 2 | 2 | 3 |
| Income before income tax expense/(benefit) | 26 | 26 | 28 | 24 | 9 | 6 |
| Income tax expense/(benefit) | 9 | 8 | 9 | 8 | 2 | (1) |
| Net income | 17% | 18% | 19% | 16% | 7% | 7% |

Key Operational Metrics Real Estate Products

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

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

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

- (1) Real estate core revenue consists of revenue for our primary real estate service offerings, HouseValues, JustListed, and HomePages. The customers from these primary service offerings are referred to as core real estate customers.

Table of Contents

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

Our core real estate customer count increased by 168 customers during the second quarter of 2006, compared to a net increase of 854 customers in the first quarter of 2006. Historically, customer growth has been the strongest in the first and third quarters. Ending core real estate customers increased 19% in the second quarter of 2006 compared to the second quarter of 2005.

Average monthly churn for our real estate business was 7.4% for the second quarter of 2006, up from 6.6% in the first quarter of 2006. Monthly churn of 7.4% equates to 92.6% monthly retention which represents a 40% annualized retention rate. Despite a higher overall churn rate, our subscriber retention curves remain relatively consistent over time. We had a higher level of customer additions in the first and third quarters of 2005. Many are now in months twelve through fourteen of the customer life cycle, a time in which we typically see higher than average monthly churn. While we expect to experience fluctuations in our churn rate from quarter to quarter, we believe our average monthly churn rate may remain at this level or increase slightly.

Average monthly revenue per real estate customer for the second quarter of 2006 decreased 6% compared to the first quarter of 2006 as a result of our broader sales focus to under-penetrated areas, some of which are lower-priced markets, as well as increased price discounting, which we believe is a result of a slower real estate market. Average revenue per customer will fluctuate from quarter to quarter, however it may decline as we incorporate lower priced markets into our customer base, or if we are forced to discount our prices in response to market conditions, competition or in an effort to accelerate our growth.

Liquidity and Capital Resources

The following table presents summary cash flow data:

| | Six months Ended June 30, | |
|---|---------------------------|-------------|
| | 2006 | 2005 |
| | (dollars in thousands) | |
| Cash provided by operating activities | \$ 8,620 | \$ 10,537 |
| Cash used in investing activities | \$ (11,889) | \$ (10,481) |
| Cash provided by (used in) financing activities | \$ 872 | \$ 40 |

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

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

Operating Activities

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

Net cash provided by operating activities primarily consists of net income adjusted for non-cash items and the effect of changes in working capital. Net cash provided by operating activities for the six months ended June 30, 2006 declined 18%

Table of Contents

from the same period in 2005. Net income decreased along with an increase in cash used for compensation and benefits, largely offset by increases in the non-cash items: depreciation, amortization, and stock-based compensation. Additionally, the tax benefit realized from the exercise of stock options was classified as an operating cash flow in 2005. In 2006, that tax benefit is classified as a financing cash flow as required with our adoption of FAS 123R.

Investing Activities

Cash used in investing activities for the six months ended June 30, 2006 increased by \$1.4 million compared to the same period last year. During the first six months of 2006, capital expenditures increased, partially offset by decreases in our net purchases of short-term investments when compared to the same period last year. Our capital expenditures were primarily related to investments in our customer-facing infrastructure and development costs related to new products and features as well as the purchase of office equipment and leasehold improvements at our new Yakima location.

Financing Activities

Cash provided by financing activities for the six months ended June 30, 2006 increased \$0.8 million primarily due to costs paid related to the public sale of our common stock in 2005. Additionally, the tax benefit realized from the exercise of stock options is now classified as a financing cash flow, as required with our adoption of FAS 123R.

Share Repurchase

In July 2006, our Board of Directors authorized us to repurchase up to 2,000,000 shares of our common stock.

Recent Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

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

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

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

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

Table of Contents

Our current and potential competitors include:

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

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

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

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

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

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

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

devote greater resources to marketing or selling their services;

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

withstand price competition more successfully than we can;

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

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

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

more effectively negotiate third-party arrangements; and

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

Table of Contents

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

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

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

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

Any failure to retain customers could harm our business.

Our ability to retain customers will depend, in part, on our ability to generate leads from prospective home buyers, sellers and mortgage consumers in quantities demanded by our customers. In addition, our success will depend on our ability to enhance our existing services, develop new technologies that address the increasingly sophisticated and varied needs of customers, respond to technological advances and emerging industry standards and practices in a timely manner and on a cost effective basis. Our real estate customer contracts and many of our mortgage customer contracts require us to deliver a guaranteed minimum number of leads per month to each customer. We occasionally fail to deliver the number of leads we are required to deliver to a customer in a given month. For example, during the quarter ended June 30, 2006, we were unable to deliver approximately 4.6% of our total guaranteed lead obligations to customers. Our estimated obligation for underdelivered leads at June 30, 2006 was approximately \$0.1 million. If we regularly fail to deliver the number of leads we are required to deliver to a customer, that customer will likely become dissatisfied with our services. In addition, if we do not maintain adequate technical support levels, or continue to improve the ease of use, functionality and features of our Market Leader prospect management system, customer coaching and training offerings, or if customers are dissatisfied with the quality of the leads that we provide, our customer may choose not to extend their contracts for our services.

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

Our customer contracts typically have an initial term of twelve months, with automatic one-month extensions unless terminated by either party. Some customers have decided not to extend their contracts due to their inability to convert the leads we have provided into closed transactions or dissatisfaction with our services. For example, our real estate average monthly churn rate for the quarter ended June 30, 2006 was 7.4%, compared to 6.6% for the quarter ended March 31, 2006. We calculate average monthly churn by dividing the number of core customers who cancel during the quarter by the average core customers in the quarter, divided by the number of months in the quarter.

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

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

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

Table of Contents

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

We have experienced rapid growth in our revenues, expenses and employee headcount. In addition to adding a number of senior individuals to our management team, our overall employee base has grown from 266 employees as of December 31, 2004 to 581 employees as of June 30, 2006. Further, we have recently opened a new facility in Yakima, Washington, which is our first location other than our corporate headquarters. This expansion has placed, and is expected to continue to place, a significant strain on our managerial, operational and financial resources.

To manage the anticipated continued growth of our operations and personnel, we will need to further expand our finance, accounting, administrative, sales and operations staff. We cannot assure you that management will be able to hire, train, retain, motivate and manage required personnel. If we are unable to manage growth effectively, our business could be harmed.

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

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

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

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

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

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

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

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

Risks Associated with Television Advertising. Television advertising rates depend on a number of factors, including the strength of the national economy and regional economies and the strength of certain industries that advertise frequently.

Table of Contents

Advertising rates are also subject to cyclical and seasonal fluctuations. If television advertising prices increase significantly, in the absence of more efficient ways to generate leads, our marketing expenses will also increase, which would harm our results of operations.

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

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

The residential real estate and mortgage markets historically have been subject to economic cycles. An economic slowdown or recession, adverse tax policies, lower availability of credit, increased interest rates, increased unemployment, lower consumer confidence, lower wage and salary levels, war or terrorist attacks or the public perception that any of these conditions may occur could decrease demand for residential real estate or mortgages. Trends in the real estate industry and mortgage business are unpredictable; therefore, our operating results, to the extent they reflect changes in the broader real estate industry and mortgage business, may be subject to significant fluctuations.

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

Our business is governed by various federal, state and local laws and regulations governing the real estate industry, including the Real Estate Settlement Procedures Act (RESPA), the Fair Housing Act, state and local real estate and mortgage

Table of Contents

broker licensing laws, federal and state laws prohibiting unfair and deceptive acts and practices, and federal and state advertising laws. We may not have always been and may not always be in compliance with each of these requirements. Failure to comply with these requirements may result in, among other things, revocation of required licenses, indemnification liability to contract counterparties, class action lawsuits, administrative enforcement actions and civil and criminal liability.

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

We regard substantial elements of our web sites, software tools and applications and underlying technology as proprietary. Despite our precautionary measures, third parties may copy or otherwise obtain and use our proprietary information without authorization or may develop similar technology independently. We may not be able to detect such infringements or may lose any competitive advantage in the market before

we do so. In addition, competitors may design

Table of Contents

around our technology or develop competing technologies substantially similar to ours. Unauthorized parties may attempt to disclose, obtain or use our technology. Our precautions may not prevent misappropriation of our intellectual property, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States. Any legal action that we may bring to protect our proprietary information could be unsuccessful and expensive and could divert management's attention from other business concerns. Legal standards relating to the validity, enforceability and scope of protection of proprietary rights in Internet-related businesses are uncertain and evolving, and we cannot assure you of the future viability or value of any of our proprietary rights.

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

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

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

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

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

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

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

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

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

Table of Contents

we are required to do so could subject us to penalties, limit our ability to market our services and hamper our ability to enforce contracts in these jurisdictions.

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

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

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

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

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

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

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

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

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

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

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

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

Through June 30, 2006, we have used approximately \$21.4 million of the proceeds to purchase property and equipment and intangible assets. The remaining proceeds have been invested in money market funds and highly liquid, short-term, adjustable-rate insured municipal notes. Our current and planned use of the proceeds does not represent a material change from the use of proceeds described in the prospectus relating to the Registration Statement.

Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of stockholders was held on May 31, 2006. The following nominees were elected as directors for three year terms expiring in 2009, by the vote set forth below. There were no broker non-votes with respect to any of the nominees.

| Nominee | For | Withheld |
|--------------------|------------|----------|
| Robert D. Blank | 23,408,166 | 230,762 |
| Nicolas J. Hanauer | 23,548,967 | 89,961 |

Continuing directors are Frank M. (Pete) Higgins and Mark S. Powell, whose terms expire in 2007 and Jon W. Gacek, Richard A. Mendenhall and Ian Morris, whose terms expire in 2008. As we disclosed in a Current Report on Form 8-K filed July 25, 2006, Mr. Blank resigned from our board of directors subsequent to the annual meeting.

Item 6. Exhibits**Exhibit**

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

* Management contract or compensatory plan

Table of Contents

SIGNATURE

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

HOUSEVALUES, INC.

By: /s/ JACQUELINE DAVIDSON
Jacqueline Davidson

Authorized Officer and Principal Financial Officer

August 2, 2006