

COSTAR GROUP INC
Form 10-Q
October 27, 2016

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

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission file number 0-24531

CoStar Group, Inc.
(Exact name of registrant as specified in its charter)
Delaware 52-2091509
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

Edgar Filing: COSTAR GROUP INC - Form 10-Q

company” in Rule 12b-2 of the Securities Exchange Act of 1934.

Large accelerated filer Accelerated filer

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

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

As of October 21, 2016, there were 32,593,441 shares of the registrant’s common stock outstanding.

COSTAR GROUP, INC.

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1.	<u>Financial Statements</u>	3
	<u>Condensed Consolidated Statements of Operations</u>	3
	<u>Condensed Consolidated Statements of Comprehensive Income (Loss)</u>	4
	<u>Condensed Consolidated Balance Sheets</u>	5
	<u>Condensed Consolidated Statements of Cash Flows</u>	6
	<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	41
Item 4.	<u>Controls and Procedures</u>	42

PART II OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	43
Item 1A.	<u>Risk Factors</u>	43
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	44
Item 3.	<u>Defaults Upon Senior Securities</u>	44
Item 4.	<u>Mine Safety Disclosures</u>	44
Item 5.	<u>Other Information</u>	44
Item 6.	<u>Exhibits</u>	44
	<u>Signatures</u>	45

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues	\$212,711	\$189,078	\$619,319	\$518,755
Cost of revenues	42,222	53,728	127,801	143,758
Gross margin	170,489	135,350	491,518	374,997
Operating expenses:				
Selling and marketing	75,414	80,506	231,086	242,418
Software development	19,357	17,048	56,539	49,040
General and administrative	30,572	31,074	88,275	86,346
Purchase amortization	5,550	7,153	17,602	21,260
	130,893	135,781	393,502	399,064
Income (loss) from operations	39,596	(431)	98,016	(24,067)
Interest and other income	344	42	587	473
Interest and other expense	(2,498)	(2,363)	(7,462)	(7,060)
Income (loss) before income taxes	37,442	(2,752)	91,141	(30,654)
Income tax expense (benefit), net	14,241	2,610	35,643	(4,199)
Net income (loss)	\$23,201	\$(5,362)	\$55,498	\$(26,455)
Net income (loss) per share — basic	\$0.72	\$(0.17)	\$1.73	\$(0.83)
Net income (loss) per share — diluted	\$0.72	\$(0.17)	\$1.71	\$(0.83)
Weighted average outstanding shares — basic	32,186	31,980	32,152	31,934
Weighted average outstanding shares — diluted	32,440	31,980	32,423	31,934

See accompanying notes.

COSTAR GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(unaudited)

	Three Months		Nine Months Ended	
	Ended		September 30,	
	September 30,			
	2016	2015	2016	2015
Net income (loss)	\$23,201	\$(5,362)	\$55,498	\$(26,455)
Other comprehensive loss, net of tax				
Foreign currency translation adjustment	(596)	(965)	(3,054)	(719)
Net decrease in unrealized loss on investments	46	8	275	256
Total other comprehensive loss	(550)	(957)	(2,779)	(463)
Total comprehensive income (loss)	\$22,651	\$(6,319)	\$52,719	\$(26,918)

See accompanying notes.

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

	September 30, 2016	December 31, 2015
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 522,099	\$ 421,818
Short-term investments	1,171	—
Accounts receivable, net of allowance for doubtful accounts of approximately \$7,324 and \$7,478 as of September 30, 2016 and December 31, 2015, respectively	47,461	40,276
Income tax receivable	1,049	430
Prepaid expenses and other current assets	11,663	10,209
Total current assets	583,443	472,733
Long-term investments	9,911	15,507
Deferred income taxes, net	8,153	9,107
Property and equipment, net	85,366	88,311
Goodwill	1,256,353	1,252,945
Intangible assets, net	207,113	238,318
Deposits and other assets	2,248	2,650
Total assets	\$ 2,152,587	\$ 2,079,571
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	\$ 21,825	\$ 16,746
Accounts payable	9,861	9,673
Accrued wages and commissions	32,443	31,045
Accrued expenses	33,252	31,423
Deferred gain on the sale of building	2,523	2,523
Income taxes payable	9,079	46
Deferred rent	2,612	1,687
Deferred revenue	41,864	42,138
Total current liabilities	153,459	135,281
Long-term debt, less current portion	315,694	338,366
Deferred gain on the sale of building	19,346	21,239
Deferred rent	29,193	29,628
Deferred income taxes, net	9,185	4,585
Income taxes payable	7,012	6,692
Total liabilities	533,889	535,791
Total stockholders' equity	1,618,698	1,543,780
Total liabilities and stockholders' equity	\$ 2,152,587	\$ 2,079,571
See accompanying notes.		

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

	Nine Months Ended September 30,	
	2016	2015
Operating activities:		
Net income (loss)	\$55,498	\$(26,455)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	17,927	14,445
Amortization	35,114	44,562
Amortization of debt issuance costs	2,407	2,486
Impairment loss	—	2,778
Excess tax benefit from stock-based compensation	(4,728)	(7,970)
Stock-based compensation expense	26,981	25,169
Deferred income tax expense (benefit), net	5,554	(13,702)
Provision for losses on accounts receivable	6,462	5,490
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(13,808)	(13,279)
Prepaid expenses and other current assets	(1,398)	263
Deposits and other assets	473	411
Accounts payable and other liabilities	12,864	30,085
Deferred revenue	386	5,433
Net cash provided by operating activities	143,732	69,716
Investing activities:		
Proceeds from sale and settlement of investments	4,700	1,900
Purchases of property and equipment and other assets	(11,692)	(27,953)
Acquisitions, net of cash acquired	(10,443)	(177,476)
Net cash used in investing activities	(17,435)	(203,529)
Financing activities:		
Payments of long-term debt	(20,000)	(15,000)
Excess tax benefit from stock-based compensation	4,728	7,970
Repurchase of restricted stock to satisfy tax withholding obligations	(14,573)	(15,816)
Proceeds from exercise of stock options and employee stock purchase plan	4,791	5,350
Net cash used in financing activities	(25,054)	(17,496)
Effect of foreign currency exchange rates on cash and cash equivalents	(962)	(194)
Net increase (decrease) in cash and cash equivalents	100,281	(151,503)
Cash and cash equivalents at the beginning of period	421,818	527,012
Cash and cash equivalents at the end of period	\$522,099	\$375,509
See accompanying notes.		

COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. ORGANIZATION

CoStar Group, Inc. (the “Company” or “CoStar”) provides information, analytics and online marketplace services to the commercial real estate and related business community through its comprehensive, proprietary database of commercial real estate information covering the United States (“U.S.”), the United Kingdom (“U.K.”), and parts of Canada, Spain, Germany and France. The Company provides online marketplaces for commercial real estate, apartment rentals, lands for sale and businesses for sale. The Company operates within two operating segments, North America and International, and its services are typically distributed to its clients under subscription-based license agreements that renew automatically, a majority of which have a term of one year.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

Interim Financial Statements

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information. In the opinion of the Company’s management, the financial statements reflect all adjustments necessary to present fairly the Company’s financial position at September 30, 2016 and December 31, 2015, the results of its operations for the three and nine months ended September 30, 2016 and 2015, its comprehensive income (loss) for the three and nine months ended September 30, 2016 and 2015, and its cash flows for the nine months ended September 30, 2016 and 2015. These adjustments are of a normal recurring nature.

Certain notes and other information have been condensed or omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

The results of operations for the three and nine months ended September 30, 2016 are not necessarily indicative of future financial results.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. On an ongoing basis, the Company evaluates its estimates and assumptions, including those related to revenue recognition, allowance for doubtful accounts, useful lives of property and equipment and intangible assets, recoverability of long-lived assets and intangible assets with definite lives, goodwill, income taxes, fair value of equity instruments, fair value of auction rate securities, accounting for business combinations and contingencies, among others. The Company bases these estimates on historical and anticipated results, trends, and various other assumptions that it believes are reasonable, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses. Actual results could differ from these estimates.

Reclassifications

Certain previously reported amounts in the condensed consolidated balance sheets as of December 31, 2015 have been reclassified to conform to the Company's current presentation to reflect current income taxes payable separately, which was previously included in accrued expenses.

7

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Advertising Costs

The Company expenses advertising costs as incurred. Advertising costs include e-commerce, television, radio, print and other media advertising. Advertising costs were approximately \$27 million and \$34 million for the three months ended September 30, 2016 and 2015, respectively. Advertising costs were approximately \$95 million and \$113 million for the nine months ended September 30, 2016 and 2015, respectively.

Foreign Currency Translation

The Company's functional currency in its foreign locations is the local currency. Assets and liabilities are translated into U.S. dollars using the exchange rates as of the balance sheet dates. Revenues, expenses, gains and losses are translated at the average exchange rates in effect during each period. Gains and losses resulting from translation are included in accumulated other comprehensive loss. Net gains or losses resulting from foreign currency exchange transactions are included in the condensed consolidated statements of operations. There were no material gains or losses from foreign currency exchange transactions for the three and nine months ended September 30, 2016 and 2015.

Accumulated Other Comprehensive Loss

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

	September 30, 2016	December 31, 2015
Foreign currency translation adjustment	\$ (10,213)	\$ (7,159)
Accumulated net unrealized loss on investments, net of tax	(160)	(435)
Total accumulated other comprehensive loss	\$ (10,373)	\$ (7,594)

There were no amounts reclassified out of accumulated other comprehensive loss to the condensed consolidated statements of operations for the three and nine months ended September 30, 2016 and 2015.

Net Income (Loss) Per Share

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

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Net Income (Loss) Per Share — (Continued)

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Numerator:				
Net income (loss)	\$23,201	\$(5,362)	\$55,498	\$(26,455)
Denominator:				
Denominator for basic net income (loss) per share — weighted-average outstanding shares	32,186	31,980	32,152	31,934
Effect of dilutive securities:				
Stock options and restricted stock	254	—	271	—
Denominator for diluted net income (loss) per share — weighted-average outstanding shares	32,440	31,980	32,423	31,934
Net income (loss) per share — basic	\$0.72	\$(0.17)	\$1.73	\$(0.83)
Net income (loss) per share — diluted	\$0.72	\$(0.17)	\$1.71	\$(0.83)

Stock options to purchase approximately 89,000 and 184,000 shares that were outstanding for the three and nine months ended September 30, 2016, respectively, were not included in the computation of diluted net income per share because the inclusion would have an anti-dilutive effect. The Company did not consider the impact of potentially dilutive securities for the three and nine months ended September 30, 2015 when calculating the diluted net loss per share because the inclusion of the potentially dilutive common shares would have an anti-dilutive effect. Shares underlying restricted common stock awards that vest based on Company performance and service conditions, that have not been achieved as of the end of the period are not included in the computation of basic or diluted earnings per share. Shares underlying restricted stock units that vest based on Company service conditions, that have not been achieved as of the end of the period are not included in the computation of basic or diluted earnings per share. The following table summarizes the shares underlying the performance-based restricted stock awards and service-based restricted stock units excluded from the basic and diluted calculation (in thousands):

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Performance-based restricted stock awards	72	55	72	55
Service-based restricted stock units	1	1	1	1
Total shares excluded from computation	73	56	73	56

Stock-Based Compensation

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

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Stock-Based Compensation — (Continued)

Stock-based compensation expense is measured at the grant date of the stock-based awards that vest over set time periods based on their fair values, and is recognized on a straight line basis as expense over the vesting periods of the awards, net of an estimated forfeiture rate. For equity instruments that vest based on performance, the Company assesses the probability of the achievement of the performance conditions at the end of each reporting period, or more frequently based upon the occurrence of events that may change the probability of whether the performance conditions would be met. If the Company's initial estimates of the achievement of the performance conditions change, the related stock-based compensation expense and timing of recognition may fluctuate from period to period based on those estimates. For equity instruments that vest based on a performance condition and a market condition, the Company estimates the fair value of each equity instrument granted on the date of grant using a Monte-Carlo simulation model. This pricing model uses multiple simulations to evaluate the probability of achieving the market condition to calculate the fair value of the awards. Stock-based compensation expense is updated based on the expected achievement of the related performance conditions at the end of each reporting period. If the performance conditions are not met, no stock-based compensation expense will be recognized, and any previously recognized stock-based compensation expense will be reversed.

Cash flows resulting from excess tax benefits are classified as part of cash flows from operating and financing activities. Excess tax benefits represent tax benefits for stock-based compensation in excess of the associated deferred tax asset for such equity compensation recorded as an increase to stockholders' equity. Net cash proceeds from the exercise of stock options and the purchase of shares under the Employee Stock Purchase Plan ("ESPP") were approximately \$1 million and \$646,000 for the three months ended September 30, 2016 and 2015, respectively. Net cash proceeds from the exercise of stock options and the purchase of shares under the ESPP were approximately \$5 million for each of the nine months ended September 30, 2016 and 2015. The Company realized approximately \$398,000 and \$418,000 of excess tax benefits from stock options exercised and restricted stock awards vested during the three months ended September 30, 2016 and 2015, respectively. The Company realized approximately \$5 million and \$8 million of excess tax benefits from stock options exercised and restricted stock awards vested during the nine months ended September 30, 2016 and 2015, respectively.

Stock-based compensation expense for stock options and restricted stock issued under equity incentive plans and stock purchases under the ESPP included in the Company's results of operations were as follows (in thousands):

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Cost of revenues	\$1,396	\$1,533	\$4,209	\$4,242
Selling and marketing	1,676	1,411	4,920	3,595
Software development	1,684	1,602	4,902	4,318
General and administrative	4,555	4,766	12,950	13,014
Total stock-based compensation	\$9,311	\$9,312	\$26,981	\$25,169

Options to purchase 3,367 shares were exercised during the three months ended September 30, 2016. There were no options exercised during the three months ended September 30, 2015. Options to purchase 24,078 and 41,068 shares were exercised during the nine months ended September 30, 2016 and 2015, respectively.

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Debt Issuance Costs

Costs incurred in connection with the issuance of long-term debt are capitalized and amortized as interest expense over the term of the related debt using the effective interest method. These amounts are reflected in the consolidated balance sheets as direct deductions from a combination of the current and long-term portions of debt. Upon a refinancing, previously capitalized debt issuance costs are expensed and included in loss on extinguishment of debt if the Company determines that there has been a substantial modification of the related debt. If the Company determines that there has not been a substantial modification of the related debt, any previously capitalized debt issuance costs are amortized as interest expense over the term of the new debt instrument using the effective interest method. The Company had capitalized debt issuance costs, net of amortization, of approximately \$7 million and \$10 million as of September 30, 2016 and December 31, 2015, respectively. The debt issuance costs are associated with the financing commitment received from JPMorgan Chase Bank, N.A. (“J.P. Morgan Bank”) on April 27, 2011, the subsequent term loan facility and revolving credit facility established under a credit agreement dated February 16, 2012 (the “2012 Credit Agreement”), the financing commitment received from J.P. Morgan Bank, Bank of America, N.A., SunTrust Bank and Wells Fargo Bank, National Association on February 28, 2014, and the subsequent term loan facility and revolving credit facility established under a credit agreement dated April 1, 2014 (the “2014 Credit Agreement”). See Note 8 for additional information regarding the term loan facility and revolving credit facility. The Company amortized debt issuance costs of approximately \$797,000 and \$830,000 for the three months ended September 30, 2016 and 2015, respectively. The Company amortized debt issuance costs of approximately \$2 million for each of the nine months ended September 30, 2016 and 2015.

Business Combinations

The Company allocates the purchase consideration to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from acquired customer bases, acquired database technology, and acquired trade names from a market participant's perspective, useful lives and discount rates. During the measurement period, the Company may record adjustments to the assets acquired and liabilities assumed. Any adjustments to provisional amounts that are identified during the measurement period are recorded in the reporting period in which the adjustment amounts are determined. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings. See Note 3 for additional information regarding the Company's business combinations.

Recent Accounting Pronouncements

There have been no developments to the Recent Accounting Pronouncements discussion included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, including the expected dates of adoption and estimated effects on the Company's condensed consolidated financial statements, except for the following:

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In May 2014, the Financial Accounting Standards Board (“FASB”) and International Accounting Standards Board (“IASB”) jointly issued a new revenue recognition standard that is designed to improve financial reporting by creating common recognition guidance for GAAP and International Financial Reporting Standards (“IFRS”). This guidance provides a robust framework for addressing revenue issues, improves the comparability of revenue recognition practices across industries, provides useful information to users of financial statements through improved disclosure requirements and simplifies the presentation of financial statements. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. From March to May of 2016, amendments to the new revenue recognition standard were issued to clarify numerous accounting topics, including, but not limited to (i) the implementation guidance on principal versus agent considerations, (ii) the identification of performance obligations, (iii) the licensing implementation guidance, (iv) the objective of the collectability criterion and (v) the application of the variable consideration guidance and modified retrospective transition method. This guidance permits the use of either a full retrospective method or a modified retrospective approach. The modified retrospective approach would be applied only to the most current period presented along with a cumulative-effect adjustment at the date of adoption. This guidance will be effective for annual reporting periods beginning after December 15, 2017, although companies may adopt the standard as early as annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Company has not yet determined when it will adopt the standard or selected a transition method and is currently evaluating the impact this guidance will have on its financial statements and related disclosures.

In February 2016, the FASB issued authoritative lease guidance to increase transparency and comparability among organizations. The guidance requires a company to recognize lease assets and lease liabilities on the balance sheet as well as disclose key information about leasing arrangements. This guidance is effective on a modified retrospective basis for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period. Early application is permitted. The Company is currently evaluating the impact this guidance will have on its financial statements and related disclosures.

In March 2016, the FASB issued authoritative guidance to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification of share-based payment transactions on the statement of cash flows. The guidance requires a company to (i) recognize all excess tax benefits and tax deficiencies as income tax expense or benefit in the statement of operations using a prospective transition method, (ii) recognize excess tax benefits in the current period regardless of whether the benefit reduces taxes payable using a modified retrospective transition method, and (iii) classify all excess tax benefits as operating activities within the statement of cash flows using either a prospective transition method or a retrospective transition method. The guidance also allows a company to (i) elect whether to estimate the number of awards expected to vest or account for forfeitures when they occur, and (ii) withhold up to the maximum statutory tax rate in the applicable jurisdiction for awards, both of which should be applied using a modified retrospective transition method. Finally, the guidance requires a company to classify the cash paid by an employer when directly withholding shares for tax withholding purposes as a financing activity within the statement of cash flows using a retrospective transition method. This guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is permitted. The Company is currently evaluating the impact this guidance will have on its financial statements and related disclosures.

In June 2016, the FASB issued authoritative guidance designed to provide financial statement users with more information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. When determining such expected credit losses, the guidance requires companies to apply a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This guidance is effective on a modified retrospective basis for annual reporting periods beginning after December 15, 2019, including interim periods within that reporting period. Companies may adopt the standard as early as annual reporting periods beginning after December 15, 2018. The Company is currently evaluating the impact this guidance will have on its financial statements and related disclosures.

COSTAR GROUP, INC.

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In August 2016, the FASB issued authoritative guidance designed to reduce the existing diversity in how certain cash receipts and cash payments are presented and classified in the consolidated statements of cash flows. This guidance is effective on a retrospective basis for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted. This guidance is not expected to have a material impact on the Company's consolidated statements of cash flows and related disclosures.

3. ACQUISITION

Pursuant to the definitive agreement and plan of merger with Network Communications, Inc. (“NCI”) dated April 27, 2015 (the “Merger Agreement”), on June 1, 2015, the Company acquired 100% of the outstanding stock of NCI and the related Apartment Finder business (collectively referred to as “Apartment Finder”) from the former stockholders of NCI. Apartment Finder provides lead generation, advertising and Internet marketing solutions to property managers and owners through its main service, ApartmentFinder.comTM. The acquisition furthered the Company's expansion into the multifamily vertical.

In consideration for the purchase of Apartment Finder, on June 1, 2015, the Company paid \$173 million in cash, including an estimated \$3 million in connection with a preliminary adjustment for net working capital as of the closing date. Pursuant to the terms of the Merger Agreement, the purchase price was increased by approximately \$21,000 following the final determination of the net working capital of NCI as of the closing date, and this amount was paid to NCI in the third quarter of 2015.

The Company applied the acquisition method to account for the Apartment Finder transaction, which requires that, among other things, assets acquired and liabilities assumed be recorded at their fair values as of the acquisition date. The following table summarizes the amounts for acquired assets and liabilities recorded at their fair values as of the acquisition date (in thousands):

Cash and cash equivalents	\$39
Accounts receivable	4,556
Goodwill	107,692
Acquired trade names and other intangible assets	23,642
Acquired customer base	21,856
Acquired database technology	4,076
Acquired building photography	2,425
Deferred income taxes, net	9,290
Other assets and liabilities	(849)
Fair value of identifiable net assets acquired	\$172,727

The net assets of Apartment Finder were recorded at their estimated fair value. In valuing acquired assets and liabilities, fair value estimates were based on, but were not limited to, future expected cash flows, market rate assumptions for contractual obligations, and appropriate discount rates.

The acquired customer base for the acquisition consisted of three distinct intangible assets, is composed of acquired customer contracts and the related customer relationships, and has a weighted average estimated useful life of ten years. The acquired database technology had an estimated useful life of five months due to the Company's intent to

replace the acquired database technology in 2015, which it did in December 2015. The acquired trade names and other intangible assets have a weighted average estimated useful life of nine years. The acquired building photography had an estimated useful life of five months. Amortization of the acquired customer base is recognized on an accelerated basis related to the expected economic benefit of the intangible asset, while amortization of the acquired database technology, acquired building photography and acquired trade names and other intangible assets is recognized on a straight-line basis over their respective estimated useful lives. Goodwill recorded in connection with this acquisition is not amortized, but is subject to annual impairment tests. The \$108 million of goodwill recorded as part of the acquisition is associated with the Company's North America operating segment. None of the goodwill recognized is expected to be deductible for income tax purposes in future periods.

COSTAR GROUP, INC.

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

3. ACQUISITION — (CONTINUED)

Goodwill is calculated as the excess of the consideration transferred over the net assets recognized and represents the future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. Specifically, the goodwill recorded as part of the Apartment Finder acquisition includes but is not limited to: (i) the expected synergies and other benefits that the Company believes will result from combining its operations with Apartment Finder's operations; and (ii) any intangible assets that do not qualify for separate recognition, such as the assembled workforce.

4. INVESTMENTS

The Company determines the appropriate classification of debt and equity investments at the time of purchase and re-evaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. The Company's investments consist of short-term and long-term variable rate debt instruments with an auction reset feature, referred to as auction rate securities ("ARS"). Available-for-sale investments with contractual maturities of one year or less are classified as short-term in the Company's condensed consolidated balance sheets. Investments are carried at fair value.

Scheduled maturities of investments classified as available-for-sale as of September 30, 2016 are as follows (in thousands):

Maturity	Fair Value
Due:	
October 1, 2016 — September 30, 2017	\$ 1,171
October 1, 2017 — September 30, 2021	—
October 1, 2021 — September 30, 2026	—
After September 30, 2026	9,911
Available-for-sale investments	\$ 11,082

The Company had no realized gains on its investments for each of the three and nine months ended September 30, 2016 and 2015. The Company had no realized losses on its investments for each of the three and nine months ended September 30, 2016 and 2015. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

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

As of September 30, 2016, the amortized cost basis and fair value of investments classified as available-for-sale were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Auction rate securities	\$ 11,242	\$ 728	\$ (888)	\$ 11,082
Available-for-sale investments	\$ 11,242	\$ 728	\$ (888)	\$ 11,082

Edgar Filing: COSTAR GROUP INC - Form 10-Q

As of December 31, 2015, the amortized cost basis and fair value of investments classified as available-for-sale were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Auction rate securities	\$ 15,942	\$ 610	\$ (1,045)	\$ 15,507
Available-for-sale investments	\$ 15,942	\$ 610	\$ (1,045)	\$ 15,507

COSTAR GROUP, INC.

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

4. INVESTMENTS — (CONTINUED)

The unrealized losses on the Company's investments as of September 30, 2016 and December 31, 2015 were generated primarily from changes in interest rates and ARS that failed to settle at auction, due to adverse conditions in the global credit markets. The losses are considered temporary, as the contractual terms of these investments do not permit the issuer to settle the security at a price less than the amortized cost of the investment. Because the Company does not intend to sell these instruments and it is not more likely than not that the Company will be required to sell these instruments prior to anticipated recovery, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2016 and December 31, 2015. See Note 5 for further discussion of the fair value of the Company's financial assets.

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

	September 30, 2016		December 31, 2015	
	Aggregate Fair Value	Unrealized Losses	Aggregate Fair Value	Unrealized Losses
Auction rate securities	\$9,911	\$ (888)	\$14,455	\$ (1,045)
Investments in an unrealized loss position	\$9,911	\$ (888)	\$14,455	\$ (1,045)

The Company did not have any investments in an unrealized loss position for less than twelve months as of September 30, 2016 and December 31, 2015.

5. FAIR VALUE

Fair value is defined as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. There is a three-tier fair value hierarchy, which categorizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) measured at fair value on a recurring basis as of September 30, 2016 (in thousands):

	Level 1	Level 2	Level 3	Total
Assets:				
Cash	\$338,510	\$ —	—	\$338,510
Money market funds	175,328	—	—	175,328
Commercial paper	8,261	—	—	8,261
Auction rate securities	—	—	11,082	11,082
Total assets measured at fair value	\$522,099	\$ —	—\$11,082	\$533,181

The following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) measured at fair value on a recurring basis as of December 31, 2015 (in thousands):

	Level 1	Level 3	Total
--	---------	---------	-------

Edgar Filing: COSTAR GROUP INC - Form 10-Q

Level
2

Assets:

Cash	\$405,597	\$	—	\$405,597
Money market funds	5,043	—	—	5,043
Commercial paper	11,178	—	—	11,178
Auction rate securities	—	—	15,507	15,507
Total assets measured at fair value	\$421,818	\$	—\$15,507	\$437,325

15

COSTAR GROUP, INC.

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

5. FAIR VALUE — (CONTINUED)

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

The following tables summarize changes in fair value of the Company's Level 3 assets for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Balance at beginning of period	\$11,036	\$16,049	\$15,507	\$17,151
Decrease in unrealized loss included in accumulated other comprehensive loss	46	8	275	256
Settlements	—	(550)	(4,700)	(1,900)
Balance at end of period	\$11,082	\$15,507	\$11,082	\$15,507

The following table summarizes changes in fair value of the Company's Level 3 assets from December 31, 2014 to September 30, 2016 (in thousands):

	Auction Rate Securities
Balance at December 31, 2014	\$17,151
Decrease in unrealized loss included in accumulated other comprehensive loss	256
Settlements	(1,900)
Balance at December 31, 2015	15,507
Decrease in unrealized loss included in accumulated other comprehensive loss	275
Settlements	(4,700)
Balance at September 30, 2016	\$11,082

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

As of September 30, 2016, the Company held ARS with \$12 million par value, all of which failed to settle at auction. The majority of these investments are of high credit quality with AAA credit ratings and are primarily student loan securities supported by guarantees from the FFELP of the U.S. Department of Education. The Company may not be able to liquidate and fully recover the carrying value of the ARS in the near term. As a result, most of these securities are classified as long-term investments in the Company's condensed consolidated balance sheet as of September 30, 2016. ARS with contractual maturities of one year or less are classified as short-term investments in the Company's condensed consolidated balance sheets. See Note 4 for further discussion of the scheduled maturities of investments classified as available-for-sale.

While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently actively trading and therefore do not currently have a readily determinable market value. The estimated fair value of the ARS no longer approximates par value. The Company used a discounted cash flow model to determine the estimated fair value of its investment in ARS as of September 30, 2016. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of contractual cash flows, liquidity risk premiums, expected holding periods and default risk. The Company updates the discounted cash flow model on a quarterly basis to reflect any changes in the assumptions used in the model and settlements of ARS

investments that occurred during the period.

The only significant unobservable input in the discounted cash flow model is the discount rate. The discount rate used represents the Company's estimate of the yield expected by a market participant from the ARS investments. The weighted average discount rate used in the discounted cash flow model as of September 30, 2016 and December 31, 2015 was approximately 6% and 5%, respectively. Selecting another discount rate within the range used in the discounted cash flow model would not result in a significant change to the fair value of the ARS.

COSTAR GROUP, INC.

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

5. FAIR VALUE — (CONTINUED)

Based on this assessment of fair value, as of September 30, 2016, the Company determined there was a net decline in the fair value of its ARS investments of approximately \$160,000. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. In addition, while a majority of the ARS are currently rated AAA, if the issuers are unable to successfully close future auctions and/or their credit ratings deteriorate, the Company may be required to record additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments.

Concentration of Credit Risk and Financial Instruments

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

6. GOODWILL

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

	North America	International	Total
Goodwill, December 31, 2014	\$ 1,114,363	\$ 24,442	\$ 1,138,805
Acquisition	112,947	2,400	115,347
Effect of foreign currency translation	—	(1,207)	(1,207)
Goodwill, December 31, 2015	1,227,310	25,635	1,252,945
Acquisitions	467	5,933	6,400
Effect of foreign currency translation	—	(2,992)	(2,992)
Goodwill, September 30, 2016	\$ 1,227,777	\$ 28,576	\$ 1,256,353

The Company recorded goodwill of approximately \$108 million in connection with the June 1, 2015 acquisition of Apartment Finder and recorded goodwill of approximately \$2 million in connection with the July 1, 2015 acquisition of the assets of Belbex Corporate, S.L., a commercial real estate information provider operating in Madrid, Spain. Additionally, the Company recorded goodwill of approximately \$5 million during the year ended December 31, 2015 and approximately \$467,000 for the nine months ended September 30, 2016, in connection with the acquisition of certain assets related to the business operations of Apartment Finder's independent distributors within various markets. Finally, the Company recorded goodwill of approximately \$6 million in connection with the May 3, 2016 acquisition of Thomas Daily GmbH ("Thomas Daily"), a commercial real estate news and information provider operating in Freiburg, Germany. The purchase accounting for the acquisition of Thomas Daily is preliminary, subject to the completion of the accounting for certain tax related items.

COSTAR GROUP, INC.

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

7. INTANGIBLE ASSETS

Intangible assets consist of the following (in thousands, except amortization period data):

	September 30, 2016	December 31, 2015	Weighted- Average Amortization Period (in years)
Capitalized product development cost	\$ 2,275	\$ 2,243	4
Accumulated amortization	(2,205)	(2,172))
Capitalized product development cost, net	70	71	
Building photography	17,375	17,677	4
Accumulated amortization	(16,246)	(15,875))
Building photography, net	1,129	1,802	
Acquired database technology	78,332	77,905	5
Accumulated amortization	(69,870)	(62,818))
Acquired database technology, net	8,462	15,087	
Acquired customer base	221,385	221,409	10
Accumulated amortization	(145,859)	(129,782))
Acquired customer base, net	75,526	91,627	
Acquired trade names and other intangible assets	153,736	153,910	13
Accumulated amortization	(31,810)	(24,179))
Acquired trade names and other intangible assets, net	121,926	129,731	
Intangible assets, net	\$ 207,113	\$ 238,318	

In February 2015, as a result of the Company's product development efforts, it launched an improved Apartments.com website with a cleaner look, information about actual rental availabilities, rents and other fees, and better search functionality. In conjunction with the launch, the Company ceased using the database technology acquired in the acquisition of Apartments.com. The Company evaluated the acquired database technology for impairment during the first quarter of 2015 and determined that the carrying value of the acquired database technology was impaired as the Company had ceased using the asset. The Company recorded an impairment charge of approximately \$1 million in cost of revenues in the condensed consolidated statements of operations within the Company's North America operating segment for the nine months ended September 30, 2015.

In June 2015, following the June 1, 2015 acquisition of Apartment Finder, the Company decided to cease providing certain Apartment Finder services. Additionally, in June 2015, the Company decided to cease development work related to a development project within Apartment Finder. The Company evaluated the acquired customer base and acquired database technology for impairment during the second quarter of 2015 and, based on that evaluation, determined that the customer base and database technology assets associated with the ceased services and development work were impaired as they were not expected to provide any economic benefit to the Company. The Company recorded an impairment charge of approximately \$1 million, most of which was recorded in general and administrative expenses in the condensed consolidated statements of operations within the Company's North America operating segment for the nine months ended September 30, 2015.

COSTAR GROUP, INC.

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

7. INTANGIBLE ASSETS — (CONTINUED)

Intangible assets are reviewed for impairment at least annually and more frequently whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. During the first quarter of 2016, the Company determined that the acquired trade names recorded in connection with the LoopNet acquisition on April 30, 2012 should be reclassified from an indefinite-lived intangible asset to a definite-lived intangible asset due to work being performed to integrate the backend systems of LoopNet and CoStar, which may result in a future re-branding effort if aspects of the two services are ultimately combined. The Company estimated the fair value of the LoopNet trade names using the relief from royalty method and concluded that no impairment existed as of March 31, 2016. The Company estimated a useful life of fifteen years for the LoopNet trade names, which are being amortized on a straight-line basis.

8. LONG-TERM DEBT

On April 1, 2014 (the “Closing Date”), the Company entered into the 2014 Credit Agreement by and among the Company, as Borrower, CoStar Realty Information, Inc., as Co-Borrower, the Lenders from time to time party thereto and JPMorgan Chase Bank, N.A., as Administrative Agent. The 2014 Credit Agreement provides for a \$400 million term loan facility and a \$225 million revolving credit facility, each with a term of five years. The proceeds of the term loan facility and the initial borrowing of \$150 million under the revolving credit facility on the Closing Date were used to refinance the 2012 Credit Agreement, including related fees and expenses, and to pay a portion of the consideration and transaction costs related to the acquisition of Apartments.com. The undrawn proceeds of the revolving credit facility are available for the Company's working capital needs and other general corporate purposes. During June 2014, the Company repaid the \$150 million initial borrowing under the revolving credit facility. The carrying value of the term loan facility approximates fair value and can be estimated through Level 3 unobservable inputs using a valuation technique based on expected cash flows discounted using the current credit-adjusted risk-free rate, which approximates the rate of interest on the term loan facility at origination.

Effective April 1, 2014, the Company terminated the 2012 Credit Agreement and repaid all amounts outstanding thereunder, which amounts totaled \$149 million. The Company evaluated the execution of the 2014 Credit Agreement and termination of the 2012 Credit Agreement and determined that the transactions did not qualify as an extinguishment of debt because the change in the present value of future cash flows between the initial term loan facility under the 2012 Credit Agreement and the new term loan facility under the 2014 Credit Agreement was not considered a substantial modification.

The revolving credit facility includes a subfacility for swingline loans of up to \$10 million, and up to \$10 million of the revolving credit facility is available for the issuance of letters of credit. The term loan facility will amortize in quarterly installments in amounts resulting in an annual amortization of 5% during each of the first, second and third years, 10% during the fourth year and 15% during the fifth year after the Closing Date, with the remainder payable at final maturity. The loans under the 2014 Credit Agreement bear interest, at the Company's option, either (i) during any interest period selected by the Company, at the London interbank offered rate for deposits in U.S. dollars with a maturity comparable to such interest period, adjusted for statutory reserves (“LIBOR”), plus an initial spread of 2% per annum, subject to adjustment based on the First Lien Secured Leverage Ratio (as defined in the 2014 Credit Agreement) of the Company, or (ii) at the greatest of (x) the prime rate from time to time announced by JPMorgan Chase Bank, N.A., (y) the federal funds effective rate plus 0.5% and (z) LIBOR for a one-month interest period plus 1%, plus an initial spread of 1% per annum, subject to adjustment based on the First Lien Secured Leverage Ratio of the Company. If an event of default occurs under the 2014 Credit Agreement, the interest rate on overdue amounts will increase by 2% per annum. The obligations under the 2014 Credit Agreement are guaranteed by all material subsidiaries of the Company and are secured by a lien on substantially all of the assets of the Company and those of

its material subsidiaries, in each case subject to certain exceptions, pursuant to security and guarantee documents entered into on the Closing Date.

The 2014 Credit Agreement requires the Company to maintain (i) a First Lien Secured Leverage Ratio (as defined in the 2014 Credit Agreement) not exceeding 3.5 to 1.0 during the three months ended September 30, 2016, and each full fiscal quarter thereafter and (ii) after the incurrence of additional indebtedness under certain specified exceptions in the 2014 Credit Agreement, a Total Leverage Ratio (as defined in the 2014 Credit Agreement) not exceeding 4.5 to 1.0 during the three months ended September 30, 2016, and each full fiscal quarter thereafter. The 2014 Credit Agreement also includes other covenants, including covenants that, subject to certain exceptions, restrict the ability of the Company and its subsidiaries to (i) incur additional indebtedness, (ii) create, incur, assume or permit to exist any liens, (iii) enter into mergers, consolidations or similar transactions, (iv) make investments and acquisitions, (v) make certain dispositions of assets, (vi) make dividends, distributions and prepayments of certain indebtedness, and (vii) enter into certain transactions with affiliates. The Company was in compliance with the covenants in the 2014 Credit Agreement as of September 30, 2016.

COSTAR GROUP, INC.

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

8. LONG-TERM DEBT — (CONTINUED)

In connection with obtaining the term loan facility and revolving credit facility pursuant to the 2014 Credit Agreement, the Company incurred approximately \$10 million in debt issuance costs as of April 1, 2014, which along with the unamortized debt issuance cost from the 2012 Credit Agreement, were capitalized and are amortized as interest expense over the term of the 2014 Credit Agreement using the effective interest method.

As of September 30, 2016 and December 31, 2015, no amounts were outstanding under the revolving credit facility. Total interest expense for the term loan facility and revolving credit facility was approximately \$2 million for each of the three months ended September 30, 2016 and 2015. Total interest expense for the term loan facility and revolving credit facility was approximately \$7 million for each of the nine months ended September 30, 2016 and 2015. Interest expense included amortized debt issuance costs of approximately \$797,000 and \$830,000 for the three months ended September 30, 2016 and 2015, respectively. Interest expense included amortized debt issuance costs of approximately \$2 million for each of the nine months ended September 30, 2016 and 2015. Total interest paid for the term loan facility and revolving credit facility was approximately \$2 million for each of the three months ended September 30, 2016 and 2015. Total interest paid for the term loan facility and revolving credit facility was approximately \$5 million for each of the nine months ended September 30, 2016 and 2015.

The following table represents the Company's long-term debt (in thousands):

	September 30, 2016	December 31, 2015
Term loan facility	\$ 345,000	\$ 365,000
Debt issuance costs, net	(7,481) (9,888
Total debt	337,519	355,112
Current maturities of long-term debt	(25,000) (20,000
Current debt issuance costs, net	3,175	3,254
Total long-term debt, less current portion	\$ 315,694	\$ 338,366

9. INCOME TAXES

The income tax provision for the nine months ended September 30, 2016 and 2015 reflects an effective tax rate of approximately 39% and 14%, respectively. The change in the effective tax rate is primarily due to a larger impact of nondeductible expenses during the nine months ended September 30, 2015 and a change in local tax law that occurred during the first quarter of 2015.

10. COMMITMENTS AND CONTINGENCIES

The Company leases office facilities and office equipment under various non-cancelable operating leases. The leases contain various renewal options.

On April 1, 2014, the Company entered into the 2014 Credit Agreement. The 2014 Credit Agreement provides for a \$400 million term loan facility and a \$225 million revolving credit facility, each with a term of five years. See Note 8 for additional information regarding the term loan facility and revolving credit facility.

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. In accordance with GAAP, the Company records a provision for a liability when it is both probable that a liability has

been incurred and the amount can be reasonably estimated. At the present time, while it is reasonably possible that an unfavorable outcome may occur as a result of one or more of the Company's current litigation matters, management has concluded that it is not probable that a loss has been incurred in connection with the Company's current litigation. In addition, the Company is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome in the Company's current litigation and accordingly, the Company has not recognized any liability in the condensed consolidated financial statements for unfavorable results, if any. Legal defense costs are expensed as incurred.

COSTAR GROUP, INC.

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

11. SEGMENT REPORTING

Segment Information

The Company manages its business geographically in two operating segments, with the primary areas of measurement and decision-making being North America, which includes the U.S. and Canada, and International, which includes the U.K., Spain, Germany and France. The Company and its subsidiaries' subscription-based services consist primarily of information, analytics and online marketplace services offered over the Internet to commercial real estate industry and related professionals. The Company's subscription-based information services consist primarily of CoStar Suite® services. CoStar Suite is sold as a platform of service offerings consisting of CoStar Property Professional®, CoStar COMPS Professional® and CoStar Tenant® and through the Company's mobile application, CoStar Go®. CoStar Suite is the Company's primary service offering in the North America and International operating segments. Management relies on an internal management reporting process that provides revenue and operating segment net income (loss) before interest, income taxes, depreciation and amortization ("EBITDA"). Management believes that operating segment EBITDA is an appropriate measure for evaluating the operational performance of the Company's operating segments. EBITDA is used by management to internally measure operating and management performance and to evaluate the performance of the business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues				
North America	\$205,637	\$182,556	\$598,757	\$500,059
International				
External customers	7,074	6,522	20,562	18,696
Intersegment revenue	3	4	24	25
Total International revenue	7,077	6,526	20,586	18,721
Intersegment eliminations	(3)	(4)	(24)	(25)
Total revenues	\$212,711	\$189,078	\$619,319	\$518,755
EBITDA				
North America	\$56,305	\$20,993	\$148,296	\$32,816
International	1,371	1,096	2,761	2,124
Total EBITDA	\$57,676	\$22,089	\$151,057	\$34,940

The reconciliation of net income (loss) to EBITDA consists of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss)	\$23,201	\$(5,362)	\$55,498	\$(26,455)
Purchase amortization in cost of revenues	5,736	9,964	17,119	22,887
Purchase amortization in operating expenses	5,550	7,153	17,602	21,260
Depreciation and other amortization	6,794	5,403	18,320	14,860
Interest income	(344)	(42)	(587)	(473)

Edgar Filing: COSTAR GROUP INC - Form 10-Q

Interest expense	2,498	2,363	7,462	7,060
Income tax expense (benefit), net	14,241	2,610	35,643	(4,199)
EBITDA	\$57,676	\$22,089	\$151,057	\$34,940

21

COSTAR GROUP, INC.

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

11. SEGMENT REPORTING — (CONTINUED)

Segment Information — (Continued)

Intersegment revenue recorded was attributable to services performed for the Company's wholly owned subsidiary, CoStar Portfolio Strategy by Grecom S.A.S. ("Grecom"), a wholly owned subsidiary of CoStar Limited, the Company's wholly owned U.K. holding company.

North America EBITDA includes an allocation of approximately \$70,000 and \$225,000 for the three months ended September 30, 2016 and 2015, respectively. North America EBITDA includes an allocation of approximately \$379,000 and \$763,000 for the nine months ended September 30, 2016 and 2015, respectively. This allocation represents costs incurred for International employees involved in development activities of the Company's North America operating segment.

International EBITDA includes a corporate allocation of approximately \$113,000 and \$74,000 for the three months ended September 30, 2016 and 2015, respectively. International EBITDA includes a corporate allocation of approximately \$246,000 and \$200,000 for the nine months ended September 30, 2016 and 2015, respectively. This corporate allocation represents costs incurred for North America employees involved in management and expansion activities of the Company's International operating segment.

COSTAR GROUP, INC.

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

11. SEGMENT REPORTING — (CONTINUED)

Segment Information — (Continued)

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

	September 30, 2016	December 31, 2015
Property and equipment, net		
North America	\$ 83,415	\$ 86,191
International	1,951	2,120
Total property and equipment, net	\$ 85,366	\$ 88,311
Goodwill		
North America	\$ 1,227,777	\$ 1,227,310
International	28,576	25,635
Total goodwill	\$ 1,256,353	\$ 1,252,945
Assets		
North America	\$ 2,205,725	\$ 2,130,202
International	45,990	41,370
Total operating segment assets	\$ 2,251,715	\$ 2,171,572
Reconciliation of operating segment assets to total assets		
Total operating segment assets	\$ 2,251,715	\$ 2,171,572
Investment in subsidiaries	(18,344)	(18,344)
Intersegment receivables	(80,784)	(73,657)
Total assets	\$ 2,152,587	\$ 2,079,571
Liabilities		
North America	\$ 523,844	\$ 525,566
International	71,094	72,544
Total operating segment liabilities	\$ 594,938	\$ 598,110
Reconciliation of operating segment liabilities to total liabilities		
Total operating segment liabilities	\$ 594,938	\$ 598,110
Intersegment payables	(61,049)	(62,319)
Total liabilities	\$ 533,889	\$ 535,791

COSTAR GROUP, INC.

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

11. SEGMENT REPORTING — (CONTINUED)

Revenues by Services

The Company provides information, analytics and online marketplaces to the commercial real estate industry. The revenue by type of service consists of the following (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Information and analytics				
CoStar Suite ⁽¹⁾	\$ 103,261	\$ 91,350	\$ 301,969	\$ 266,931
Information services ⁽²⁾	19,486	19,126	58,336	56,415
Online marketplaces				
Multifamily ⁽³⁾	57,654	49,312	164,752	110,187
Commercial property and land ⁽⁴⁾	32,310	29,290	94,262	85,222
Total revenues	\$ 212,711	\$ 189,078	\$ 619,319	\$ 518,755

⁽¹⁾ CoStar Suite is comprised of CoStar Property Professional, CoStar COMPS Professional, CoStar Tenant; CoStar Market Analytics; and CoStar Portfolio Strategy.

⁽²⁾ Information services is comprised of LoopNet Premium Searcher; CoStar Real Estate Manager; CoStar Risk Analytics COMPASS; CoStar Investment Analysis Portfolio Maximizer; CoStar Investment Analysis Request; CoStar Brokerage Applications; PROPEX; Grecam; Belbex and Thomas Daily.

⁽³⁾ Multifamily is comprised of Apartments.com, ApartmentFinder.com and ApartmentHomeLiving.com.

⁽⁴⁾ Commercial property and land is comprised of LoopNet Premium Lister; LoopLink; CoStar Advertising; BizBuySell and BizQuest; LandsofAmerica and LandAndFarm; and CoStar Private Sale Network.

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

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

All forward-looking statements are based on information available to us on the date of this filing and we assume no obligation to update such statements, whether as a result of new information, future events or otherwise. The following discussion should be read in conjunction with our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other filings with the Securities and Exchange Commission and the condensed consolidated financial statements and related notes included in this Quarterly Report on Form 10-Q.

Overview

CoStar Group, Inc. (the "Company" or "CoStar") is the number one provider of information, analytics and online marketplaces to the commercial real estate industry in the United States ("U.S.") and the United Kingdom ("U.K.") based on the fact that we offer the most comprehensive commercial real estate database available; have the largest research department in the industry; own and operate leading online marketplaces for commercial real estate and apartment listings in the U.S. based on the numbers of unique visitors and site visits per month; provide more information, analytics and marketing services than any of our competitors and believe that we generate more revenues than any of our commercial real estate information competitors. We created and compiled our standardized platform of information, analytics and online marketplace services where industry professionals and consumers of commercial real estate, including apartments, and the related business communities can continuously interact and facilitate transactions by efficiently accessing and exchanging accurate and standardized real estate-related information.

We have five flagship brands - CoStar®, LoopNet®, Apartments.com™, BizBuySell® and LandsOfAmerica™. Our subscription-based services consist primarily of information, analytics and online marketplace services offered over the Internet to commercial real estate industry and related professionals. Our subscription-based information services consist primarily of CoStar Suite® services. CoStar Suite is sold as a platform of service offerings consisting of CoStar Property Professional®, CoStar COMPS Professional® and CoStar Tenant® and through our mobile application, CoStar Go®. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, information about properties for sale, tenant information, Internet marketing services, analytical capabilities, information for clients' websites, information about industry professionals and their business relationships, data integration and industry news. We provide market research and analysis for commercial real estate investors and lenders via our CoStar Portfolio Strategy and CoStar Market Analytics service offerings; portfolio and debt analysis, management and reporting capabilities through our CoStar Investment Analysis and CoStar Risk Analytics service offerings; and, real estate and lease management solutions, including lease administration and abstraction services, through our CoStar Real Estate Manager service offerings.

Our LoopNet subscription-based online marketplace services enable commercial property owners, landlords, and real estate agents working on their behalf to list properties for sale or for lease and to submit detailed information about property listings. Commercial real estate agents, buyers and tenants also use LoopNet's online marketplace services to search for available property listings that meet their criteria.

Apartments.com is part of our network of apartment marketing sites, which also includes ApartmentFinder.com™ and ApartmentHomeLiving.com. Our apartment marketing network of subscription-based services offers renters a searchable database of apartment listings and provides professional property management companies and landlords

with an advertising destination.

Our BizBuySell services, which include BizQuest®, provide an online marketplace for operating businesses for sale. Our LandsofAmerica services, which include LandAndFarm, provide an online marketplace for rural lands for sale.

Our service offerings span all commercial property types, including office, retail, industrial, multifamily, commercial land, mixed-use and hospitality.

Subscription-Based Services

Our subscription-based services consist primarily of information, analytics and online marketplace services offered over the Internet to commercial real estate industry and related professionals. Our services are typically distributed to our clients under subscription-based license agreements that renew automatically, a majority of which have a term of one year. Upon renewal, many of the subscription contract rates may change in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than charging fees based on actual system usage or number of paid clicks. Depending on the type of service, contract rates are generally based on the number of sites, number of users, organization size, the client's business focus, geography, the number and types of services to which a client subscribes, the number of properties a client advertises and the prominence and placement of a client's advertised properties in the search results. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis.

Our subscription-based information services consist primarily of CoStar Suite® services. CoStar Suite is sold as a platform of service offerings consisting of CoStar Property Professional®, CoStar COMPS Professional® and CoStar Tenant® and through our mobile application, CoStar Go®. CoStar Suite is our primary service offering in our North America and International operating segments.

As of September 30, 2016 and 2015, our annualized net new sales of subscription-based services on annual contracts were approximately \$24 million and \$31 million, respectively, calculated based on the annualized amount of change in our sales resulting from new annual subscription-based contracts or upsales on existing annual subscription-based contracts, less write downs and cancellations, for the period reported. As of September 30, 2016 and September 30, 2015, our annualized net bookings of subscription-based contracts were approximately \$26 million and \$31 million, calculated based on the annualized amount of change in our sales resulting from all new subscription-based contracts or upsales on all existing subscription-based contracts, less write downs and cancellations, for the period reported. We recognize subscription revenue on a straight-line basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

For each of the twelve months ended September 30, 2016 and 2015, our contract renewal rate for existing CoStar subscription-based services on annual contracts was approximately 91% and 90%, respectively, and therefore our cancellation rate for those services was approximately 9% and 10%, respectively, for the same time periods. Our contract renewal rate is a quantitative measurement that is typically closely correlated with our revenue results. As a result, management also believes that the rate may be a reliable indicator of short-term and long-term performance. Our trailing twelve-month contract renewal rate may decline if, among other reasons, negative economic conditions lead to greater business failures and/or consolidations among our clients, reductions in customer spending, or decreases in our customer base.

Apartment Rental Marketplaces

On April 1, 2014 (the "Closing Date"), we increased our presence in the multifamily vertical by acquiring from Classified Ventures, LLC ("CV") certain assets and assuming certain liabilities, in each case, related to the Apartments.com business (collectively referred to as "Apartments.com"), a national online apartment rentals resource for renters, property managers and owners. The Apartments.com network of rental websites also includes ApartmentHomeLiving.com, another national online apartment rentals resource. To further support our expansion into the multifamily vertical, on June 1, 2015, we acquired Network Communications, Inc. ("NCI"), including its Apartment Finder business (collectively referred to as "Apartment Finder"). Apartments.com and Apartment Finder offer renters a database of apartment listings and provide professional property management companies and landlords an advertising

destination.

In 2015, we launched the improved Apartments.com and ApartmentFinder.com websites to meet renter preferences and demands, and in an effort to drive traffic to those sites and attract advertisers who prefer to advertise on heavily trafficked apartment websites. These sites draw on CoStar's multifamily database and provide a comprehensive selection of rentals, information on actual availabilities and rents, and in-depth data on neighborhoods, including restaurants, nightlife, history, schools and other facts important to renters. To help renters find the information that meets their needs, the sites also offer innovative search tools such as the PolygonTM Search, which allows renters to specifically define the area in which they want to find an apartment. Apartments.com also offers Plan Commute tools, which allow renters to search property listings that meet their transportation needs.

In 2015, we entered into an agreement to be the exclusive third party provider of listings in apartment communities with 50 units or more to websites owned and operated by News Corp. subsidiary Move, Inc. - realtor.com®, move.com, and doorsteps.com - with advertiser content from Apartments.com and ApartmentFinder.com. As a result, we are able to promote the apartment communities of our advertisers across the “Apartments Network” consisting of Apartments.com, ApartmentFinder.com, ApartmentHomeLiving.com, realtor.com, move.com and doorsteps.com - six major apartment and real estate rental websites, increasing traffic across our network of apartment marketing websites, and in turn increasing the lead flow to our advertisers’ communities.

Similar to our other past acquisitions, we have been, and plan to continue, integrating, further developing and cross-selling the services offered by Apartments.com and ApartmentFinder.com and the other services we offer, including but not limited to CoStar Market Analytics. We have incurred and plan to continue to incur product development costs to improve the online Apartments.com and ApartmentFinder.com platforms. We have incurred sales and marketing expenses in order to support Apartments.com and to increase brand awareness. In conjunction with the launch of the improved Apartments.com website, we embarked on a wide-scale marketing campaign in 2015 to generate brand awareness and site traffic for Apartments.com. The marketing campaign featured television and radio advertising, online/digital advertising, social media and out-of-home ads and was reinforced by Search Engine Marketing. We also increased our Search Engine Marketing to support Apartment Finder. In early 2016, we ran a Super Bowl ad to continue to generate brand awareness and site traffic for Apartments.com. We expect to continue to invest in sales and marketing throughout 2016. As we continue to assess the success and effectiveness of our marketing campaign, we will continue to work to determine the optimal level of marketing investment for future periods.

Development and Expansion

We expect to continue our software development efforts to improve existing services, introduce new services, integrate and cross-sell services, and expand and develop supporting technologies for our research, sales and marketing organizations. We are committed to supporting and improving our information, news, analytic and online marketplace solutions.

The launch of the improved Apartments.com and ApartmentFinder.com websites in 2015 are examples of our software development efforts to improve existing services, introduce new services, and integrate and cross-sell existing services. We believe the improved sites, enhanced search capabilities, availability of information regarding real-time vacancies, and our continued development and introduction of enhancements to our online apartment rental marketplaces are attracting more consumers, making these sites more attractive to property managers, and increasing our cross-selling opportunities. We believe greater functionality makes our services valuable to an even broader audience and helps us increase sales of our services to brokers, banks, owners, institutional investors and other industry participants. We expect technology enhancements to continue to drive revenue growth in 2016 and for the foreseeable future.

We are working to integrate the backend systems of the LoopNet and CoStar databases, so that the two services will share a unified database of information in order to create efficiencies in operations and improve the data available to our customers. We also hope to increase the quantity and quality of the listing information available by enabling select brokers and other industry participants to load information directly into the integrated system, simultaneously reducing the time and costs associated with researching and maintaining our comprehensive database of commercial real estate information.

We evaluate potential changes to our service offerings from time to time in order to better align the services we offer with customers’ needs. Further, in some cases, when integrating and coordinating our services and assessing industry and client needs, we may decide to combine, shift focus from, de-emphasize, phase out, or eliminate a service that,

among other things, overlaps or is redundant with other services we offer. In the event that we eliminate or phase out particular service offerings, we may experience reduced revenues and earnings. The decision to eliminate or phase out a service offering may also ultimately result in increased revenues and earnings from sales of other services we offer in lieu of the eliminated or phased out services. For example, in 2015, we eliminated certain Apartment Finder services, phased out Apartment Finder print advertising and moved to an all-digital offering. We experienced a short-term reduction in revenues and associated costs resulting from the elimination of these Apartment Finder services. Additionally, we continue to assess whether to transition the LoopNet marketplace to a pure marketing site for commercial real estate where, eventually, all listings would be paid and users could search the site for free. If and when we implement such a shift, we will seek to convert LoopNet marketplace customers to higher value, more profitable annual subscription information services, which should increase revenues and earnings over time. However, we cannot predict with certainty the amount or timing of any reductions in revenues and earnings, or subsequent increases in revenues and earnings, if any, resulting from any eliminations or phasing out of the LoopNet information services or any other service offering, if implemented.

Our revenues have increased as a result of revenue from acquired businesses and from cross-selling opportunities among the customers of CoStar and the acquired companies. We expect to continue to increase revenues as a result of such cross-selling opportunities. We may incur increased expenses in connection with any marketing and sales campaigns involving cross-selling opportunities and initiatives and in connection with promotion of our new services and brands.

We are expanding the geographic reach of our North America services. In 2014, we began offering our services in Toronto, Canada. Building on our experience in Toronto, we have expanded and are continuing to expand our research into additional Canadian cities. In the second quarter of 2015, we began offering services in Calgary and Vancouver. In the second quarter of 2016, we began offering services in Ottawa and in the third quarter of 2016, we began offering services in the Canadian city of Edmonton. Further, on July 1, 2015, we expanded our International services into Madrid, Spain through the acquisition of the assets of Belbex Corporate, S.L. (“Belbex”), a commercial real estate information provider operating in Madrid. On May 3, 2016, we expanded our International services into key markets in Germany, through the acquisition of Thomas Daily GmbH (“Thomas Daily”), a commercial real estate news and information provider operating in Freiburg.

We have invested in the expansion and development of our field sales force to support the growth and expansion of our company in North America and internationally. We plan to continue to invest in, evaluate and strategically position our sales force as the Company continues to develop and grow. We are also investing in our research operations to support continued growth of our information and analytics offerings, to support Apartments.com and Apartment Finder, to expand into additional Canadian markets and to provide services in Madrid, Spain and key markets in Germany. We recently announced that we will establish our research operations headquarters in Richmond, Virginia. The Richmond research headquarters is expected to be a technology innovation hub, powering the software development necessary to support the content within our information, analytics and marketing services. In connection with the opening of the Richmond research headquarters, we plan to expand the research team to continue our investment in research operations to meet the growth content needs of our clients. While we believe investments we make in our business create a platform for growth, those investments may reduce our profitability and adversely affect our financial position.

We believe that our integration efforts and continued investments in our services, including expansion of our existing service offerings, have created a platform for long-term revenue growth. We expect these investments to result in further penetration of our subscription-based services and the successful cross-selling of our services to customers in existing markets.

We intend to continue to assess the need for additional investments in our business, in addition to the investments discussed above, in order to develop and distribute new services within our current platform or expand the reach of our current service offerings. Any future product development or expansion of services, combination and coordination of services or elimination of services or corporate expansion, development or restructuring efforts could reduce our profitability and increase our capital expenditures. Any new investments, changes to our service offerings or other unforeseen events could cause us to generate losses and negative cash flow from operations in the future. Any development efforts must comply with our credit facility, which contains restrictive covenants that restrict our operations and use of our cash flow and may prevent us from taking certain actions that we believe could increase our profitability or otherwise enhance our business.

Financial Matters

Our financial reporting currency is the U.S. dollar. Changes in exchange rates can significantly affect our reported results and consolidated trends. We believe that our increasing diversification beyond the U.S. economy through our international businesses benefits our stockholders over the long term. We also believe it is important to evaluate our

operating results before and after the effect of currency changes, as it may provide a more accurate comparison of our results of operations over historical periods. On June 23, 2016, the U.K. held a referendum in which British citizens approved an exit from the European Union (“E.U.”), commonly referred to as “Brexit.” Global markets and currencies have been adversely impacted as a result of the referendum, including a sharp decline in the value of the British pound as compared to the U.S. dollar. Currency exchange rate volatility may continue generally and may increase as the British government negotiates the terms of the U.K.’s withdrawal from the E.U. The exchange rate volatility may impact (either positively or negatively) our reported financial results and consolidated trends and period-to-period comparisons of our consolidated operations.

We currently issue stock options, restricted stock and/or restricted stock units to our officers, directors and employees, and as a result we record compensation expense in our condensed consolidated statements of operations. The amount and timing of the compensation expense that we record depends on the amount and types of equity grants made. We plan to continue to use stock-based compensation for our officers, directors and employees, which may include, among other things, restricted stock, restricted stock units or stock option grants that typically will require us to record additional compensation expense in our condensed consolidated statements of operations and reduce our net income. Grants of equity awards may vest over time or based on achievement of pre-approved performance conditions and market conditions.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. The following accounting policies involve a “critical accounting estimate” because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different acceptable assumptions would yield different results. Changes in the accounting estimates are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary.

Fair Value of Auction Rate Securities

Fair value is defined as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. There is a three-tier fair value hierarchy, which categorizes assets and liabilities by the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions. Our Level 3 assets consist of auction rate securities (“ARS”), whose underlying assets are primarily student loan securities supported by guarantees from the Federal Family Education Loan Program (“FFELP”) of the U.S. Department of Education.

Our ARS investments are not currently actively trading and therefore do not currently have a readily determinable market value. The estimated fair value of the ARS no longer approximates par value. We have used a discounted cash flow model to determine the estimated fair value of our investment in ARS as of September 30, 2016. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of contractual cash flows, liquidity risk premiums, expected holding periods and default risk of the ARS. We update the discounted cash flow model on a quarterly basis to reflect any changes in the assumptions used in the model and settlements of ARS investments that occurred during the period.

The only significant unobservable input in the discounted cash flow model is the discount rate. The discount rate used represents our estimate of the yield expected by a market participant from the ARS investments. The weighted average discount rate used in the discounted cash flow model as of September 30, 2016 and December 31, 2015 was approximately 6% and 5%, respectively. Selecting another discount rate within the range used in the discounted cash flow model would not result in a significant change to the fair value of the ARS.

Based on this assessment of fair value, as of September 30, 2016, we determined there was a net decline in the fair value of our ARS investments of approximately \$160,000. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders’ equity. If the issuers of these ARS are unable to successfully close future auctions and/or their credit ratings deteriorate, we may be required to record additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments, which would reduce our profitability and adversely affect our financial position.

We have not made any material changes in the accounting methodology used to determine the fair value of the ARS. We do not expect any material changes in the near term to the underlying assumptions used to determine the unobservable inputs used to calculate the fair value of the ARS as of September 30, 2016. However, if changes in

these assumptions occur, and, should those changes be significant, we may be exposed to additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments.

Stock-Based Compensation

We account for equity instruments issued in exchange for employee services using a fair-value based method, and we recognize the fair value of such equity instruments as an expense in the condensed consolidated statements of operations. We estimate the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, which requires us to estimate the dividend yield, expected volatility, risk-free interest rate and expected life of the stock option. For equity instruments that vest based on a market condition, we estimate the fair value of each equity instrument granted on the date of grant using a Monte-Carlo simulation model, which also requires us to estimate the dividend yield, expected volatility, risk-free interest rate and expected life of the equity instruments. These assumptions and the estimation of expected forfeitures are based on multiple factors, including historical employee behavior patterns of exercising options and post-employment termination behavior, expected future employee option exercise patterns, and the historical volatility of our stock price. For equity instruments that vest based on performance, we assess the probability of the achievement of the performance conditions at the end of each reporting period, or more frequently based upon the occurrence of events that may change the probability of whether the performance conditions would be met. If our initial estimates of the achievement of the performance conditions change, the related stock-based compensation expense and timing of recognition may fluctuate from period to period based on those estimates. If the performance conditions are not met, no stock-based compensation expense will be recognized, and any previously recognized stock-based compensation expense will be reversed.

We do not expect any material changes in the near term to the underlying assumptions used to calculate stock-based compensation expense for the nine months ended September 30, 2016. However, if changes in these assumptions occur, and, should those changes be significant, they could have a material impact on our stock-based compensation expense.

Business Combinations

We allocate the purchase consideration to the tangible assets acquired, liabilities assumed and intangible assets acquired based on their estimated fair values. The excess of the fair value of purchase consideration over the fair values of these identifiable assets and liabilities is recorded as goodwill. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets. Significant estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from acquired customer bases, acquired database technology, and acquired trade names from a market participant's perspective, useful lives and discount rates. During the measurement period, we may record adjustments to the assets acquired and liabilities assumed. Any adjustments to provisional amounts that are identified during the measurement period are recorded in the reporting period in which the adjustment amounts are determined. Upon the conclusion of the measurement period, any subsequent adjustments are recorded to earnings.

Valuation of Long-Lived and Intangible Assets and Goodwill

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

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

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

Goodwill and identifiable intangible assets that are not subject to amortization are tested annually for impairment by each reporting unit on October 1 of each year and are also tested for impairment more frequently based upon the existence of one or more of the above indicators.

To determine whether it is necessary to perform the two-step goodwill impairment test, we may first assess qualitative factors to evaluate whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If we conclude that it is more likely than not that the fair value of a reporting unit is less than its carrying amount or if we elect not to assess qualitative factors, then we perform the two-step process. The first step is to determine the fair value of each reporting unit. We estimate the fair value of each reporting unit based on a projected discounted cash flow model that includes significant assumptions and estimates including our discount rate, growth rate and future financial performance. Assumptions about the discount rate are based on a weighted average cost of capital for comparable companies. Assumptions about the growth rate and future financial performance of a reporting unit are based on our forecasts, business plans, economic projections and anticipated future cash flows. Our assumptions regarding the future financial performance of the International reporting unit reflect our expectation as of October 1, 2015, that revenues will continue to increase as a result of further penetration of our international subscription-based services, including into Madrid, Spain, and the successful cross-selling of our services to our customers in existing markets due to the release of our upgraded international platform and expansion of coverage of our international service offerings. These assumptions are subject to change from period to period and could be adversely impacted by the uncertainty surrounding global market conditions, commercial real estate conditions, and the competitive environment in which we operate. Changes in these or other factors could negatively affect our reporting units' fair value and potentially result in impairment charges. Such impairment charges could have an adverse effect on our results of operations.

The fair value of each reporting unit is compared to the carrying amount of the reporting unit. If the carrying value of the reporting unit exceeds the fair value, then the second step of the process is performed to measure the impairment loss. We estimate the fair value of our reporting units based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk in our current business model. As of October 1, 2015, the date of our most recent impairment analysis, the estimated fair value of each of our reporting units substantially exceeded the carrying value of our reporting units. There have been no events or changes in circumstances since the date of our impairment analysis on October 1, 2015 that would indicate that the carrying value of each reporting unit may not be recoverable.

To determine whether it is necessary to perform the quantitative impairment test for indefinite-lived intangible assets, we may first assess qualitative factors to evaluate whether it is more likely than not that the fair value of the indefinite-lived intangible assets is less than the carrying amount. If we conclude that it is more likely than not that the fair value of the indefinite-lived intangible assets is less than the carrying amount or if we elect not to assess qualitative factors, then we perform a quantitative impairment test. We estimate the fair value of our existing indefinite-lived intangible assets using the relief from royalty method that includes significant assumptions and estimates including our discount rate, revenue growth rate and royalty rate. Assumptions about the discount rate are based on a weighted average cost of capital for comparable companies. Assumptions about the revenue growth rate are based on our forecasts, business plans and economic projections. Assumptions about the royalty rate are based on royalty agreements for comparable companies with similar intangible assets.

As of October 1, 2015, the date of our most recent annual impairment analysis, the estimated fair value of our indefinite-lived intangible assets substantially exceeded the carrying value. During the first quarter of 2016, we determined that the acquired trade names recorded in connection with the LoopNet acquisition on April 30, 2012 should be reclassified from an indefinite-lived intangible asset to a definite-lived intangible asset due to work being performed to integrate the backend systems of LoopNet and CoStar, which may result in a future re-branding effort if aspects of the two services are ultimately combined. We estimated the fair value of the LoopNet trade names using the relief from royalty method and concluded that no impairment existed as of March 31, 2016. We estimated a useful life of fifteen years for the LoopNet trade names, which are being amortized on a straight-line basis.

In February 2015, as a result of our product development efforts, we launched the improved Apartments.com website with a cleaner look, information about actual rental availabilities, rents and other fees, and better search functionality. In conjunction with the launch, we ceased using the database technology acquired in the acquisition of Apartments.com. We evaluated the acquired database technology for impairment during the first quarter of 2015 and determined that the carrying value of the acquired database technology was impaired as we had ceased using the asset. As a result, we recorded an impairment charge of approximately \$1 million in cost of revenues in the condensed consolidated statements of operations within our North America operating segment for the nine months ended September 30, 2015.

In June 2015, following the June 1, 2015 acquisition of Apartment Finder, the Company decided to cease providing certain Apartment Finder services. Additionally, in June 2015, the Company decided to cease development work related to a development project within Apartment Finder. The Company evaluated the acquired customer base and acquired database technology for impairment during the second quarter of 2015 and, based on that evaluation, determined that the customer base and database technology assets associated with the ceased services and development work were impaired as they were not expected to provide any economic benefit to the Company. The Company recorded an impairment charge of approximately \$1 million, most of which was recorded in general and administrative expenses in the condensed consolidated statements of operations within the Company's North America operating segment for the nine months ended September 30, 2015.

Accounting for Income Taxes

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

Non-GAAP Financial Measures

We prepare and publicly release quarterly unaudited financial statements prepared in accordance with GAAP. We also disclose and discuss certain non-GAAP financial measures in our public releases, investor conference calls and filings with the Securities and Exchange Commission. The non-GAAP financial measures that we may disclose include EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share (also referred to as "non-GAAP EPS"). EBITDA is our net income (loss) before interest, income taxes, depreciation and amortization. We typically disclose EBITDA on a consolidated and an operating segment basis in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. Adjusted EBITDA is different from EBITDA because we further adjust EBITDA for stock-based compensation expense, acquisition- and integration-related costs, restructuring costs and settlements and impairments incurred outside our ordinary course of business. Non-GAAP net income and non-GAAP net income per diluted share are similarly adjusted for stock-based compensation expense, acquisition- and integration-related costs, restructuring costs, settlement and impairment costs incurred outside our ordinary course of business as well as purchase amortization and other related costs. We may disclose adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share on a consolidated basis in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. The non-GAAP financial measures that we use may not be comparable to similarly titled measures reported by other companies. Also, in the future, we may disclose different non-GAAP financial measures in order to help our investors meaningfully evaluate and compare our results of operations to our previously reported results of operations or to those of other companies in our industry.

We view EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share as operating performance measures and as such we believe that the most directly comparable GAAP financial measure is net income (loss). In calculating EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share, we exclude from net income (loss) the financial items that we believe should be separately identified to provide additional analysis of the financial components of the day-to-day operation of our business. We have outlined

below the type and scope of these exclusions and the material limitations on the use of these non-GAAP financial measures as a result of these exclusions. EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share are not measurements of financial performance under GAAP and should not be considered as a measure of liquidity, as an alternative to net income (loss) or as an indicator of any other measure of performance derived in accordance with GAAP. Investors and potential investors in our securities should not rely on EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share as a substitute for any GAAP financial measure, including net income (loss). In addition, we urge investors and potential investors in our securities to carefully review the GAAP financial information included as part of our Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q that are filed with the Securities and Exchange Commission, as well as our quarterly earnings releases, and compare the GAAP financial information with our EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share.

EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share may be used by management to internally measure our operating and management performance and may be used by investors as supplemental financial measures to evaluate the performance of our business. We believe that these non-GAAP measures, when viewed with our GAAP results and the accompanying reconciliation, provide additional information that is useful to understand the factors and trends affecting our business. We have spent more than 28 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complementary businesses. Due to the expansion of our information, analytics and online marketplace services, which has included acquisitions, our net income (loss) has included significant charges for purchase amortization, depreciation and other amortization, acquisition- and integration-related costs and restructuring costs. Adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share exclude these charges and provide meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization, acquisition- and integration-related costs, restructuring costs and settlement and impairment costs incurred outside our ordinary course of business. We believe the disclosure of non-GAAP measures can help investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe the non-GAAP measures we disclose are measures of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and other items, such as interest, income taxes, stock-based compensation expenses, acquisition- and integration-related costs, restructuring costs and settlement and impairment costs incurred outside our ordinary course of business, provides additional information about our cost structure, and, over time, helps track our operating progress. In addition, investors, securities analysts and others have regularly relied on EBITDA and may rely on adjusted EBITDA, non-GAAP net income or non-GAAP net income per diluted share to provide a financial measure by which to compare our operating performance against that of other companies in our industry.

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

Purchase amortization in cost of revenues may be useful for investors to consider because it represents the diminishing value of any acquired trade names and other intangible assets and the use of our acquired database technology, which is one of the sources of information for our database of commercial real estate information. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.

Purchase amortization in operating expenses may be useful for investors to consider because it represents the estimated attrition of our acquired customer base. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.

Depreciation and other amortization may be useful for investors to consider because they generally represent the wear and tear on our property and equipment used in our operations. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.

The amount of interest income we generate may be useful for investors to consider and may result in current cash inflows. However, we do not consider the amount of interest income to be a representative component of the day-to-day operating performance of our business.

The amount of interest expense we incur may be useful for investors to consider and may result in current cash outflows. However, we do not consider the amount of interest expense to be a representative component of the day-to-day operating performance of our business.

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

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

Purchase amortization in cost of revenues, purchase amortization in operating expenses, depreciation and other amortization, interest income, interest expense, and income tax expense as previously described above with respect to the calculation of EBITDA.

Stock-based compensation expense may be useful for investors to consider because it represents a portion of the compensation of our employees and executives. Determining the fair value of the stock-based instruments involves a high degree of judgment and estimation and the expenses recorded may bear little resemblance to the actual value realized upon the future exercise or termination of the related stock-based awards. Therefore, we believe it is useful to exclude stock-based compensation in order to better understand the long-term performance of our core business.

The amount of acquisition- and integration-related costs incurred may be useful for investors to consider because they generally represent professional service fees and direct expenses related to acquisitions. Because we do not acquire businesses on a predictable cycle we do not consider the amount of acquisition- and integration-related costs to be a representative component of the day-to-day operating performance of our business.

The amount of restructuring costs incurred may be useful for investors to consider because they generally represent costs incurred in connection with a change in a contract or a change in the makeup of our properties or personnel. We do not consider the amount of restructuring related costs to be a representative component of the day-to-day operating performance of our business.

- The amount of material settlement and impairment costs incurred outside of our ordinary course of business may be useful for investors to consider because they generally represent gains or losses from the settlement of litigation matters or impairments on acquired intangible assets. We do not believe these charges necessarily reflect the current and ongoing cash charges related to our operating cost structure.

The financial items that have been excluded from our net income (loss) to calculate non-GAAP net income and non-GAAP net income per diluted share are purchase amortization and other related costs, stock-based compensation, acquisition- and integration-related costs, restructuring costs and settlement and impairment costs incurred outside our ordinary course of business. These items are discussed above with respect to the calculation of adjusted EBITDA together with the material limitations associated with using this non-GAAP financial measure as compared to net income (loss). We subtract an assumed provision for income taxes to calculate non-GAAP net income. In 2015 and 2016, we assumed a 38% tax rate in order to approximate our long-term effective corporate tax rate.

Non-GAAP net income per diluted share is a non-GAAP financial measure that represents non-GAAP net income divided by the number of diluted shares outstanding for the period used in the calculation of GAAP net income (loss) per diluted share.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss)	\$23,201	\$(5,362)	\$55,498	\$(26,455)
Purchase amortization in cost of revenues	5,736	9,964	17,119	22,887
Purchase amortization in operating expenses	5,550	7,153	17,602	21,260
Depreciation and other amortization	6,794	5,403	18,320	14,860
Interest income	(344)	(42)	(587)	(473)
Interest expense	2,498	2,363	7,462	7,060

Edgar Filing: COSTAR GROUP INC - Form 10-Q

Income tax expense (benefit), net	14,241	2,610	35,643	(4,199)
EBITDA	\$57,676	\$22,089	\$151,057	\$34,940

Net cash flows provided by (used in)

Operating activities	\$61,368	\$42,760	\$143,732	\$69,716
Investing activities	(3,946)	(14,282)	(17,435)	(203,529)
Financing activities	746	(4,379)	(25,054)	(17,496)

Comparison of Three Months Ended September 30, 2016 and Three Months Ended September 30, 2015

Revenues. Revenues increased to \$213 million for the three months ended September 30, 2016, from \$189 million for the three months ended September 30, 2015. The \$24 million increase was primarily attributable to further penetration of our subscription-based services and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates.

Gross Margin. Gross margin increased to \$170 million for the three months ended September 30, 2016, from \$135 million for the three months ended September 30, 2015. The gross margin percentage increased to 80% for the three months ended September 30, 2016, from 72% for the three months ended September 30, 2015. The increase in the gross margin amount and percentage was principally due to an increase in revenues as well as a decrease in cost of revenues of \$12 million. The decrease in cost of revenues was primarily due to a \$4 million decrease in the amortization of intangible assets and a \$4 million decrease in research personnel costs.

Selling and Marketing Expenses. Selling and marketing expenses decreased to \$75 million for the three months ended September 30, 2016, from \$81 million for the three months ended September 30, 2015, and decreased as a percentage of revenues to 35% for the three months ended September 30, 2016, compared to 43% for the three months ended September 30, 2015. The decrease in the amount and percentage of selling and marketing expenses was primarily due to a decrease in marketing expense for the wide-scale marketing campaign to generate brand awareness and site traffic for Apartments.com during the three months ended September 30, 2016, compared to the three months ended September 30, 2015.

Software Development Expenses. Software development expenses increased to \$19 million for the three months ended September 30, 2016, from \$17 million for the three months ended September 30, 2015, and remained relatively consistent as a percentage of revenues at 9% for each of the three months ended September 30, 2016 and 2015. The increase in the amount of software development expenses was primarily due to an increase in personnel costs to support enhancements and upgrades to our services.

General and Administrative Expenses. General and administrative expenses remained relatively consistent at \$31 million for each of the three months ended September 30, 2016 and 2015, and decreased as a percentage of revenues to 14% for the three months ended September 30, 2016, compared to 16% for the three months ended September 30, 2015.

Purchase Amortization Expense. Purchase amortization expense decreased to \$6 million for the three months ended September 30, 2016, compared to \$7 million for the three months ended September 30, 2015, and decreased as a percentage of revenues to 3% for the three months ended September 30, 2016, compared to 4% for the three months ended September 30, 2015. The decrease in the amount and percentage of purchase amortization expense was primarily due to the accelerated amortization of acquired customer bases for the three months ended September 30, 2015, compared to the three months ended September 30, 2016.

Interest and Other Income. Interest and other income increased to \$344,000 for the three months ended September 30, 2016, from approximately \$42,000 for the three months ended September 30, 2015. The increase was primarily due to our lower average cash and cash equivalent balance in 2015 resulting from the June 1, 2015 acquisition of Apartment Finder.

Interest and Other Expense. Interest and other expense remained relatively consistent at approximately \$2 million for each of the three months ended September 30, 2016 and 2015.

Income Tax Expense (Benefit), Net. Income tax expense, net increased to \$14 million for the three months ended September 30, 2016, from \$3 million for the three months ended September 30, 2015. This increase was primarily due to higher income before income taxes for the three months ended September 30, 2016, as compared to the three months ended September 30, 2015, as a result of our increased revenues and decreased operating expenses.

Comparison of Business Segment Results for Three Months Ended September 30, 2016 and Three Months Ended September 30, 2015

We manage our business geographically in two operating segments, with our primary areas of measurement and decision-making being North America, which includes the U.S. and Canada, and International, which includes the U.K., Spain, Germany and France. Management relies on an internal management reporting process that provides revenue and operating segment EBITDA, which is our net income (loss) before interest, income taxes, depreciation and amortization. Management believes that operating segment EBITDA is an appropriate measure for evaluating the operational performance of our operating segments. EBITDA is used by management to internally measure our operating and management performance and to evaluate the performance of our business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

Segment Revenues. North America revenues increased to \$206 million for the three months ended September 30, 2016, from \$183 million for the three months ended September 30, 2015. This increase in North America revenue was primarily due to further penetration of our subscription-based services and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates. International revenues remained relatively consistent at \$7 million for each of the three months ended September 30, 2016 and 2015, primarily due to the fact that an increase in revenues due to further penetration of our subscription-based services resulting from sales of CoStar Suite was offset by the negative impact of foreign currency fluctuations.

Segment EBITDA. North America EBITDA increased to \$56 million for the three months ended September 30, 2016, from \$21 million for the three months ended September 30, 2015. The increase in North America EBITDA was primarily due to an increase in revenues. International EBITDA remained relatively consistent at \$1 million for each of the three months ended September 30, 2016 and 2015, primarily due to the fact that an increase in revenues was offset by the negative impact of foreign currency fluctuations. North America EBITDA includes an allocation of approximately \$70,000 and \$225,000 for the three months ended September 30, 2016 and 2015, respectively. This allocation represents costs incurred for International employees involved in development activities of the Company's North America operating segment. International EBITDA includes a corporate allocation of approximately \$113,000 and \$74,000 for the three months ended September 30, 2016 and 2015, respectively. This corporate allocation represents costs incurred for North America employees involved in management and expansion activities of the Company's International operating segment.

Comparison of Nine Months Ended September 30, 2016 and Nine Months Ended September 30, 2015

Revenues. Revenues increased to \$619 million for the nine months ended September 30, 2016, from \$519 million for the nine months ended September 30, 2015. The \$100 million increase was primarily attributable to increased revenues of approximately \$55 million from our Apartments Network, as well as the further penetration of our subscription-based services and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates.

Gross Margin. Gross margin increased to \$492 million for the nine months ended September 30, 2016, from \$375 million for the nine months ended September 30, 2015. The gross margin percentage increased to 79% for the nine months ended September 30, 2016, from 72% for the nine months ended September 30, 2015. The increase in the gross margin amount and percentage was principally due to an increase in revenues as well as a decrease in cost of revenues of \$16 million. The decrease in cost of revenues was primarily due to a \$6 million decrease in the amortization of intangible assets and a \$6 million decrease in research personnel costs.

Selling and Marketing Expenses. Selling and marketing expenses decreased to \$231 million for the nine months ended September 30, 2016, from \$242 million for the nine months ended September 30, 2015, and decreased as a percentage of revenues to 37% for the nine months ended September 30, 2016, compared to 47% for the nine months ended September 30, 2015. The decrease in the amount and percentage of selling and marketing expenses was primarily due to a decrease in marketing expense for the wide-scale marketing campaign to generate brand awareness and site traffic for Apartments.com during the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015.

Software Development Expenses. Software development expenses increased to \$57 million for the nine months ended September 30, 2016, from \$49 million for the nine months ended September 30, 2015, and remained relatively consistent as a percentage of revenues at 9% for each of the nine months ended September 30, 2016 and 2015. The increase in the amount of software development expenses was primarily due to an increase in personnel costs to support enhancements and upgrades to our services.

General and Administrative Expenses. General and administrative expenses increased to \$88 million for the nine months ended September 30, 2016, from \$86 million for the nine months ended September 30, 2015, and decreased as a percentage of revenues to 14% for the nine months ended September 30, 2016, compared to 17% for the nine months ended September 30, 2015. The increase in the amount of general and administrative expenses was primarily due to an increase in bad debt expense.

Purchase Amortization Expense. Purchase amortization expense decreased to \$18 million for the nine months ended September 30, 2016, compared to \$21 million for the nine months ended September 30, 2015, and decreased as a percentage of revenues to 3% for the nine months ended September 30, 2016, compared to 4% for the nine months ended September 30, 2015. The decrease in the amount and percentage of purchase amortization expense was primarily due to the accelerated amortization of acquired customer bases for the nine months ended September 30, 2015, compared to the nine months ended September 30, 2016.

Interest and Other Income. Interest and other income increased to approximately \$587,000 for the nine months ended September 30, 2016, compared to approximately \$473,000 for the nine months ended September 30, 2015. The increase was primarily due to our higher average cash, cash equivalent and investment balances during the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015.

Interest and Other Expense. Interest and other expense remained relatively consistent at approximately \$7 million for each of the nine months ended September 30, 2016 and 2015.

Income Tax Expense, Net. Income tax expense (benefit), net changed to a \$36 million income tax expense for the nine months ended September 30, 2016, from a \$4 million income tax benefit for the nine months ended September 30, 2015. This change was primarily due to higher income before income taxes for the nine months ended September 30, 2016, as compared to the nine months ended September 30, 2015, as a result of our increased revenues and decreased operating expenses.

Comparison of Business Segment Results for Nine Months Ended September 30, 2016 and Nine Months Ended September 30, 2015

Segment Revenues. North America revenues increased to \$599 million for the nine months ended September 30, 2016, from \$500 million for the nine months ended September 30, 2015. This increase in North America revenue was primarily due to increased revenue of approximately \$55 million from our Apartments Network, as well as the further penetration of our subscription-based services and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates. International revenues increased to \$21 million for the nine months ended September 30, 2016, compared to \$19 million for the nine months ended September 30, 2015. This increase was primarily due to further penetration of our subscription-based services resulting from sales of CoStar Suite.

Segment EBITDA. North America EBITDA increased to \$148 million for the nine months ended September 30, 2016, from \$33 million for the nine months ended September 30, 2015. The increase in North America EBITDA was primarily due to an increase in revenues. International EBITDA increased to \$3 million for the nine months ended September 30, 2016, from \$2 million for the nine months ended September 30, 2015. The increase in International

EBITDA was primarily due to an increase in revenues. North America EBITDA includes an allocation of approximately \$379,000 and \$763,000 for the nine months ended September 30, 2016 and 2015, respectively. This allocation represents costs incurred for International employees involved in development activities of the Company's North America operating segment. International EBITDA includes a corporate allocation of approximately \$246,000 and \$200,000 for the nine months ended September 30, 2016 and 2015, respectively. This corporate allocation represents costs incurred for North America employees involved in management and expansion activities of the Company's International operating segment.

Liquidity and Capital Resources

Our principal sources of liquidity are cash, cash equivalents and debt from our term loan and revolving credit facility. Total cash, cash equivalents and short-term investments increased to \$523 million as of September 30, 2016 compared to cash and cash equivalents of \$422 million as of December 31, 2015. The increase in cash, cash equivalents and short-term investments for the nine months ended September 30, 2016 was primarily due to net cash provided by operating activities of approximately \$144 million, partially offset by payments of long-term debt of \$20 million.

Changes in cash and cash equivalents are dependent upon changes in, among other things, working capital items such as accounts receivable, accounts payable, various accrued expenses and deferred revenues, as well as changes in our capital structure due to stock option exercises and similar events.

Net cash provided by operating activities for the nine months ended September 30, 2016 was approximately \$144 million compared to approximately \$70 million for the nine months ended September 30, 2015. This \$74 million increase was primarily due to an increase of \$98 million in net income plus non-cash items, partially offset by a net decrease of \$24 million in changes in operating assets and liabilities. The \$24 million net decrease in changes in operating assets and liabilities was primarily due to differences in timing of payments of disbursements.

Net cash used in investing activities for the nine months ended September 30, 2016 was approximately \$17 million compared to approximately \$204 million for the nine months ended September 30, 2015. This \$187 million decrease in investing activities was primarily due to the \$177 million of cash used for the acquisition of Apartment Finder on June 1, 2015 compared to the \$10 million of cash used for the acquisitions of Thomas Daily and certain assets related to the business operations of Apartment Finder's independent distributors for the nine months ended September 30, 2016.

Net cash used in financing activities was approximately \$25 million for the nine months ended September 30, 2016 compared to approximately \$17 million for the nine months ended September 30, 2015. This \$8 million increase in net cash used in financing activities was primarily due to an increase in the payments of long-term debt resulting from a \$15 million prepayment of the principal payments for our term loan facility due over the next three quarters on April 29, 2016.

Our future capital requirements will depend on many factors, including, among others, our operating results, expansion and integration efforts, and our level of acquisition activity or other strategic transactions.

During the nine months ended September 30, 2016, we incurred capital expenditures of approximately \$12 million. We expect to make aggregate capital expenditures in 2016 of approximately \$18 million to \$23 million, primarily related to the build out of leased office space and investment in technology, including the Richmond research headquarters.

In conjunction with the launch of the improved Apartments.com website, we embarked on a wide-scale marketing campaign in 2015 to generate brand awareness and site traffic for Apartments.com. In 2016, we ran a Super Bowl ad to continue to generate brand awareness and site traffic for Apartments.com. We expect to continue to invest in sales and marketing, including sales and marketing for Apartments.com and our other brands as we seek to continue to grow the number of our subscribers and advertisers.

To date, we have grown in part by acquiring other companies and we expect to continue to make acquisitions. Our acquisitions may vary in size and could be material to our current operations. We may use cash, stock, debt or other means of funding to make these acquisitions.

In consideration for the purchase of Apartment Finder, on June 1, 2015, we paid \$173 million in cash, including an estimated \$3 million in connection with a preliminary net working capital adjustment as of the closing date. Pursuant to the terms of the agreement and plan of merger, the purchase price was increased by approximately \$21,000 following the final determination of the net working capital of NCI as of the closing date, and this amount was paid to NCI in the third quarter of 2015.

The term loan facility available to us under a credit agreement dated April 1, 2014 (the “2014 Credit Agreement”), provides for a \$400 million term loan facility and a \$225 million revolving credit facility, each with a term of five years. The undrawn proceeds of the revolving credit facility are available for our working capital needs and other general corporate purposes. As of September 30, 2016, maturities of our borrowings under the 2014 Credit Agreement for each of the next three years ended September 30, 2017 to 2019, are expected to be \$25 million, \$50 million and \$270 million, respectively. On April 29, 2016, we prepaid the principal payments for our term loan facility due over the next three quarters, for an aggregate prepayment amount of \$15 million.

The revolving credit facility includes a subfacility for swingline loans of up to \$10 million, and up to \$10 million of the revolving credit facility is available for the issuance of letters of credit. The term loan facility will amortize in quarterly installments in amounts resulting in an annual amortization of 5% during each of the first, second and third years, 10% during the fourth year and 15% during the fifth year after the Closing Date, with the remainder payable at final maturity. The loans under the 2014 Credit Agreement bear interest, at our option, either (i) during any interest period selected by us, at the London interbank offered rate for deposits in U.S. dollars with a maturity comparable to such interest period, adjusted for statutory reserves (“LIBOR”), plus an initial spread of 2% per annum, subject to adjustment based on our First Lien Secured Leverage Ratio (as defined in the 2014 Credit Agreement), or (ii) at the greatest of (x) the prime rate from time to time announced by JPMorgan Chase Bank, N.A., (y) the federal funds effective rate plus 0.5% and (z) LIBOR for a one-month interest period plus 1%, plus an initial spread of 1% per annum, subject to adjustment based on our First Lien Secured Leverage Ratio. If an event of default occurs under the 2014 Credit Agreement, the interest rate on overdue amounts will increase by 2% per annum. The obligations under the 2014 Credit Agreement are guaranteed by all of our material subsidiaries and are secured by a lien on substantially all of our assets and those of our material subsidiaries, in each case subject to certain exceptions, pursuant to security and guarantee documents entered into on the Closing Date.

The 2014 Credit Agreement requires us to maintain (i) a First Lien Secured Leverage Ratio (as defined in the 2014 Credit Agreement) not exceeding 3.5 to 1.0 during the three months ended September 30, 2016, and each full fiscal quarter thereafter and (ii) after the incurrence of additional indebtedness under certain specified exceptions in the 2014 Credit Agreement, a Total Leverage Ratio (as defined in the 2014 Credit Agreement) not exceeding 4.5 to 1.0 during the three months ended September 30, 2016, and each full fiscal quarter thereafter. The 2014 Credit Agreement also includes other covenants, including covenants that, subject to certain exceptions, restrict our ability to (i) incur additional indebtedness, (ii) create, incur, assume or permit to exist any liens, (iii) enter into mergers, consolidations or similar transactions, (iv) make investments and acquisitions, (v) make certain dispositions of assets, (vi) make dividends, distributions and prepayments of certain indebtedness, and (vii) enter into certain transactions with affiliates. We were in compliance with the covenants in the 2014 Credit Agreement as of September 30, 2016.

As of September 30, 2016 and December 31, 2015, no amounts were outstanding under our revolving credit facilities. Total interest expense for our term loan facilities and revolving credit facilities was approximately \$2 million for each of the three months ended September 30, 2016 and 2015. Total interest expense for our term loan facilities and revolving credit facilities was approximately \$7 million for each of the nine months ended September 30, 2016 and 2015. Interest expense included amortized debt issuance costs of approximately \$797,000 and \$830,000 for the three months ended September 30, 2016 and 2015, respectively. Interest expense included amortized debt issuance costs of approximately \$2 million for each of the nine months ended September 30, 2016 and 2015. Total interest paid for the term loan facility and revolving credit facility was approximately \$2 million for each of the three months ended September 30, 2016 and 2015. Total interest paid for the term loan facility and revolving credit facility was approximately \$5 million for each of the nine months ended September 30, 2016 and 2015.

Based on current plans, we believe that our available cash combined with positive cash flow provided by operating activities should be sufficient to fund our operations for at least the next 12 months.

As of September 30, 2016, we had \$12 million par value of short-term and long-term investments in student loan ARS, which failed to settle at auctions. The majority of these investments are of high credit quality with AAA credit ratings and are primarily securities supported by guarantees from the FFELP of the U.S. Department of Education. While we continue to earn interest on these investments, most of the investments are not liquid in the short-term. In the event we need to immediately access these funds, we may have to sell these securities at an amount below par value. Based on our ability to access our cash and cash equivalents, and our expected operating cash flows, we do not anticipate having to sell these investments below par value in order to operate our business in the foreseeable future.

Recent Accounting Pronouncements

See Note 2 to the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for information on recent accounting pronouncements, including the expected dates of adoption and estimated effects, if any, on our condensed consolidated financial statements and related disclosures.

Cautionary Statement Concerning Forward-Looking Statements

We have made forward-looking statements in this Report and make forward-looking statements in our press releases and conference calls that are subject to risks and uncertainties. Forward-looking statements include information that is not purely historic fact and include, without limitation, statements concerning our financial outlook for 2016 and beyond, our possible or assumed future results of operations generally, and other statements and information regarding assumptions about our revenues, net income (loss), net income (loss) per share, fully diluted net income (loss) per share, EBITDA, adjusted EBITDA, non-GAAP net income, non-GAAP net income per share, weighted-average outstanding shares, taxable income (loss), cash flow from operating activities, available cash, operating costs, amortization expense, intangible asset recovery, capital and other expenditures, effective tax rate, equity compensation charges, future taxable income, purchase amortization, pending acquisitions, the anticipated benefits of completed or proposed acquisitions, the anticipated benefits of cross-selling efforts, product development and release, the anticipated benefits of combining the backend systems of CoStar and LoopNet, any future re-branding effort if we combine certain aspects of the CoStar and LoopNet services, sales and marketing campaigns, product integrations, elimination and de-emphasizing of services, contract renewal rate, the timing of future payments of principal under our \$400 million term loan facility available to us under the 2014 Credit Agreement, expectations regarding our compliance with financial and restrictive covenants in the 2014 Credit Agreement, financing plans, geographic expansion, capital structure, contractual obligations, legal proceedings and claims, our database, database growth, services and facilities, employee relations, future economic performance, our ability to liquidate or realize our short-term and long-term investments, management's plans, goals and objectives for future operations, and growth and markets for our stock. Sections of this Report which contain forward-looking statements include the Financial Statements and related Notes, "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Quantitative and Qualitative Disclosures About Market Risk," "Controls and Procedures," "Legal Proceedings" and "Risk Factors."

Our forward-looking statements are also identified by words such as "hope," "anticipate," "may," "believe," "expect," "intend," "will," "should," "plan," "estimate," "predict," "continue" and "potential" or the negative of these terms or other comparable terminology. You should understand that these forward-looking statements are estimates reflecting our judgment, beliefs and expectations, not guarantees of future performance. They are subject to a number of assumptions, risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the forward-looking statements. The following important factors, in addition to those discussed or referred to under the heading "Risk Factors," and other unforeseen events or circumstances, could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in our forward-looking statements: commercial real estate market conditions; general economic conditions, both domestic and international; our ability to identify, acquire and integrate acquisition candidates; our ability to realize the expected benefits, cost savings or other synergies from acquisitions, including the acquisitions of Apartments.com, Apartment Finder, Thomas Daily and the assets of Belbex, on a timely basis or at all; our ability to combine acquired businesses successfully or in a timely and cost-efficient manner; business disruption relating to integration of acquired businesses or other business initiatives; the amount of investment for sales and marketing and our ability to realize a return on investments in sales and marketing; our ability to effectively and strategically combine, eliminate or de-emphasize service offerings; reductions in revenues as a result of service changes; the time and resources required to develop upgraded or new services and to expand service offerings; changes or consolidations within the commercial real estate industry; customer retention; our ability to attract new clients; our ability to sell additional services to existing clients; our ability to integrate our North America and International product offerings; our ability to integrate the backend systems of CoStar and LoopNet and subsequently create efficiencies in operations and improved data for our customers; our ability to successfully introduce and cross-sell new products or upgraded services in U.S. and foreign markets; our ability to attract consumers to our online marketplaces; the success of our marketing campaigns in generating brand awareness and site traffic; competition; foreign currency fluctuations; global credit market conditions affecting investments; our ability to continue to expand successfully, timely and in a cost-efficient manner,

including internationally; our ability to effectively penetrate and gain acceptance in new sectors and geographies; our ability to control costs; litigation; changes in accounting policies or practices; release of new and upgraded services or entry into new markets by us or our competitors; data quality; expansion, growth, development or reorganization of our sales force; employee retention; technical problems with our services; managerial execution; changes in relationships with real estate brokers, property managers, financial institutions and other strategic partners; legal and regulatory issues; and successful adoption of and training on our services.

Accordingly, you should not place undue reliance on forward-looking statements, which speak only as of, and are based on information available to us on, the date of this Report. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to update any such statements or release publicly any revisions to these forward-looking statements to reflect new information or events or circumstances after the date of this Report or to reflect the occurrence of unanticipated events.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We provide information, analytics and online marketplace services to the commercial real estate and related business community in the U.S., the U.K., and parts of Canada, Spain, Germany and France. Our functional currency for our operations in the U.K., Canada, Spain, Germany, and France is the local currency. As such, fluctuations in the British Pound, Canadian dollar and Euro may have an impact on our business, results of operations and financial position. We currently do not use financial instruments to hedge our exposure to exchange rate fluctuations with respect to our foreign subsidiaries. We may seek to enter into hedging transactions in the future to reduce our exposure to exchange rate fluctuations, but we may be unable to enter into hedging transactions successfully, on acceptable terms or at all. As of September 30, 2016, accumulated other comprehensive loss included a loss from foreign currency translation adjustments of approximately \$10 million.

We do not have material exposure to market risks associated with changes in interest rates related to cash equivalent securities held as of September 30, 2016. As of September 30, 2016, we had \$523 million of cash, cash equivalents and short-term investments. If there is an increase or decrease in interest rates, there will be a corresponding increase or decrease in the amount of interest earned on our cash and cash equivalents.

As of September 30, 2016, we had \$345 million of long-term debt bearing interest at a variable rate of LIBOR plus 2%, subject to adjustment based on our First Lien Secured Leverage Ratio (as defined in the 2014 Credit Agreement). If there is an increase or decrease in interest rates, there will be a corresponding increase or decrease in the amount of interest expense on our long-term debt. Based on our outstanding borrowings as of September 30, 2016, an increase in the interest rate by 25 basis points would result in an increase of approximately \$900,000 in interest expense annually. Based on our outstanding borrowings as of September 30, 2016, a decrease in the interest rate by 25 basis points would result in a decrease of approximately \$900,000 in interest expense annually. Based on our ability to access our cash and cash equivalents, and our expected operating cash flows, we do not believe that increases or decreases in interest rates will impact our ability to operate our business in the foreseeable future.

Included within our short-term and long-term investments are investments in mostly AAA-rated student loan ARS. These securities are primarily securities supported by guarantees from the FFELP of the U.S. Department of Education. As of September 30, 2016, \$12 million of our investments in ARS failed to settle at auction. As a result, we may not be able to sell these investments at par value until a future auction on these investments is successful. In the event we need to immediately liquidate these investments, we may have to locate a buyer outside the auction process, who may be unwilling to purchase the investments at par, resulting in a loss. Based on an assessment of fair value of these investments in ARS as of September 30, 2016, we determined that there was a net decline in the fair value of our ARS investments of approximately \$160,000, which was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. If the issuers are unable to successfully close future auctions and/or their credit ratings deteriorate, we may be required to adjust the carrying value of these investments as a temporary impairment and recognize a greater unrealized loss in accumulated other comprehensive loss or as an other-than-temporary impairment charge to earnings. Based on our ability to access our cash and cash equivalents, and our expected operating cash flows, we do not anticipate having to sell these securities below par value in order to operate our business in the foreseeable future. See Notes 4 and 5 to the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for further discussion.

We had approximately \$1 billion in intangible assets as of September 30, 2016. As of September 30, 2016, we believe our intangible assets will be recoverable, however, changes in the economy, the business in which we operate and our own relative performance could change the assumptions used to evaluate intangible asset recoverability. In the event that we determine that an asset has been impaired, we would recognize an impairment charge equal to the amount by which the carrying amount of the assets exceeds the fair value of the asset. We continue to monitor these assumptions

and their effect on the estimated recoverability of our intangible assets.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of September 30, 2016, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at a reasonable assurance level.

There have been no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Currently, and from time to time, we are involved in litigation incidental to the conduct of our business. We are not a party to any lawsuit or proceeding that, in the opinion of our management based on consultations with legal counsel, is likely to have a material adverse effect on our financial position or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, “Item 1A Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”), which could materially affect our business, financial condition or future results. The risks described in our 2015 Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or results of operations. Other than the risk factors discussed below, there have been no material changes to the Risk Factors as previously disclosed in Part I, “Item 1A Risk Factors” in our 2015 Form 10-K.

The economic effects of “Brexit” may affect relationships with existing and future customers and could have an adverse impact on our business and operating results. On June 23, 2016, the U.K held a referendum in which British citizens approved an exit from the European Union (“E.U.”), commonly referred to as “Brexit.” The referendum is non-binding; however, if passed into law, negotiations would commence to determine the future terms of the U.K.’s relationship with the E.U. The impact to us from Brexit will depend, in part, on the outcome of tariff, trade, regulatory and other negotiations. This impact may affect not only our U.K. operations but operations in other parts of the E.U. Any transitional or permanent agreements resulting from such negotiations could potentially disrupt the markets we serve and the tax jurisdictions in which we operate.

As a result of the referendum, the global markets and currencies have been adversely impacted, including a sharp decline in the value of the British Pound as compared to the U.S. dollar. A potential devaluation of the local currencies of our international customers relative to the U.S. dollar may impair the purchasing power of our international customers and could cause international customers to decrease or cancel orders, or terminate or fail to renew subscriptions for our services.

Volatility in exchange rates resulting from Brexit is expected to continue in the short term as the U.K negotiates its exit from the E.U. We translate sales and other results denominated in foreign currency into U.S. dollars for our financial statements. During periods of a strengthening dollar, our reported international sales and earnings could be reduced because foreign currencies may translate into fewer U.S. dollars.

The announcement of Brexit and the withdrawal of the U.K. from the E.U. may create global economic uncertainty, which may cause our customers to closely monitor their costs and reduce their spending budgets on our products and services. In addition, Brexit could lead to legal uncertainty and potentially divergent national laws and regulations as the U.K determines which E.U. laws to replace or replicate, and those laws and regulations may be cumbersome, difficult or costly in terms of compliance. Any of these effects of Brexit, among others, could adversely affect our business, financial condition, operating results and cash flows.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table is a summary of our repurchases of common stock during each of the three months in the quarter ended September 30, 2016:

ISSUER PURCHASES OF EQUITY SECURITIES

Month, 2016	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 through July 31	204	\$218.96	—	—
August 1 through August 31	—	—	—	—
September 1 through September 30	2,721	206.30	—	—
Total	2,925	(1) \$207.19	—	—

(1) The number of shares purchased consists of shares of common stock tendered by employees to the Company to satisfy the employees' minimum tax withholding obligations arising as a result of vesting of restricted stock grants under the Company's 2007 Stock Incentive Plan, as amended, which shares were purchased by the Company based on their fair market value on the vesting date. None of these share purchases were part of a publicly announced program to purchase common stock of the Company.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See exhibits listed under the Exhibit Index below.

SIGNATURES

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

COSTAR GROUP, INC.

Date: October 27, 2016 By: /s/ Scott T. Wheeler
Scott T. Wheeler
Chief Financial Officer
(Principal Financial and Accounting Officer and Duly Authorized Officer)

INDEX TO EXHIBITS

Exhibit No.	Description
2.1	Agreement and Plan of Merger, dated as of April 27, 2015, by and among CoStar Realty Information, Inc., Orange, LLC, Network Communications, Inc., and Shareholder Representative Services LLC (Incorporated by reference to Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed with the Commission on April 29, 2015).
3.1	Third Amended and Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the Commission on June 6, 2013).
3.2	Third Amended and Restated By-Laws (Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed with the Commission on September 24, 2013).
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101	The following materials from CoStar Group, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) Unaudited Condensed Consolidated Statement of Operations for the three and nine months ended September 30, 2016 and 2015, respectively; (ii) Unaudited Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2016 and 2015, respectively; (iii) Unaudited Condensed Consolidated Balance Sheets at September 30, 2016 and December 31, 2015, respectively; (iv) Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015, respectively; and (v) Notes to the Unaudited Condensed Consolidated Financial Statements that have been detail tagged.