

COSTAR GROUP INC
Form 10-Q
July 25, 2018

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 June 30, 2018

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

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filer,” “smaller reporting company,” and “emerging growth 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)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 20, 2018, there were 36,391,084 shares of the registrant’s common stock outstanding.

COSTAR GROUP, INC.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues	\$297,018	\$237,153	\$570,736	\$463,706
Cost of revenues	67,136	55,273	129,613	106,619
Gross profit	229,882	181,880	441,123	357,087
Operating expenses:				
Selling and marketing (excluding customer base amortization)	112,965	91,726	201,455	168,128
Software development	26,271	23,144	49,184	45,518
General and administrative	38,056	34,557	78,646	68,552
Customer base amortization	8,816	4,570	14,619	9,344
	186,108	153,997	343,904	291,542
Income from operations	43,774	27,883	97,219	65,545
Interest and other income	2,652	605	5,639	1,034
Interest and other expense	(728)	(2,693)	(1,418)	(5,379)
Income before income taxes	45,698	25,795	101,440	61,200
Income tax expense	1,863	3,611	5,374	16,886
Net income	\$43,835	\$22,184	\$96,066	\$44,314
Net income per share - basic	\$1.22	\$0.68	\$2.67	\$1.37
Net income per share - diluted	\$1.20	\$0.68	\$2.64	\$1.36
Weighted average outstanding shares - basic	36,073	32,406	35,983	32,341
Weighted average outstanding shares - diluted	36,450	32,739	36,400	32,651

See accompanying notes.

COSTAR GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

	Three Months		Six Months Ended	
	Ended		June 30,	
	June 30,			
	2018	2017	2018	2017
Net income	\$43,835	\$22,184	\$96,066	\$44,314
Other comprehensive (loss) income, net of tax				
Foreign currency translation adjustment	(2,059)	1,831	(1,108)	2,242
Total other comprehensive (loss) income	(2,059)	1,831	(1,108)	2,242
Total comprehensive income	\$41,776	\$24,015	\$94,958	\$46,556

See accompanying notes.

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

	June 30, 2018	December 31, 2017
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$966,278	\$ 1,211,463
Accounts receivable, less allowance for doubtful accounts of approximately \$5,065 and \$6,469 as of June 30, 2018 and December 31, 2017, respectively	69,984	60,900
Prepaid expenses and other current assets	39,723	15,572
Total current assets	1,075,985	1,287,935
Long-term investments	10,070	10,070
Deferred income taxes, net	4,046	5,431
Property and equipment, net	84,648	84,496
Goodwill	1,549,517	1,283,457
Intangible assets, net	299,611	182,892
Deferred commission costs, net	76,159	—
Deposits and other assets	7,660	6,179
Income tax receivable	14,878	12,981
Total assets	\$3,122,574	\$ 2,873,441
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$9,394	\$ 9,262
Accrued wages and commissions	45,593	54,104
Accrued expenses	37,343	22,193
Deferred gain on the sale of building	2,523	2,523
Income taxes payable	94	8,166
Deferred rent	4,632	4,732
Deferred revenue	46,341	45,686
Total current liabilities	145,920	146,666
Deferred gain on the sale of building	14,930	16,192
Deferred rent	32,230	33,909
Deferred income taxes, net	62,830	12,070
Income taxes payable	16,046	13,354
Total liabilities	271,956	222,191
Total stockholders' equity	2,850,618	2,651,250
Total liabilities and stockholders' equity	\$3,122,574	\$ 2,873,441
See accompanying notes.		

COSTAR GROUP, INC.

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands)

(unaudited)

	Common Stock		Additional	Accumulated	Retained	Total
	Shares	Amount	Paid-In Capital	Other Comprehensive Loss	Earnings	Stockholders' Equity
Balance at December 31, 2017	36,107	\$ 361	\$2,339,253	\$ (9,020)	\$320,656	\$2,651,250
Cumulative effect of adoption of new accounting standard, net of tax	—	—	—	—	54,464	54,464
Balance at January 1, 2018	36,107	\$ 361	\$2,339,253	\$ (9,020)	\$375,120	\$2,705,714
Net income	—	—	—	—	96,066	96,066
Other comprehensive income	—	—	—	(1,108)	—	(1,108)
Exercise of stock options	123	1	11,588	—	—	11,589
Restricted stock grants	126	1	(1)	—	—	—
Restricted stock grants surrendered	(76)	—	(22,394)	—	—	(22,394)
Stock-based compensation expense, net of forfeitures	—	—	21,470	—	—	21,470
Employee stock purchase plan	8	—	2,915	—	—	2,915
Stock issued for acquisitions	103	1	36,365	—	—	36,366
Balance at June 30, 2018	36,391	\$ 364	\$2,389,196	\$ (10,128)	\$471,186	\$2,850,618

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

	Six Months Ended June 30,	
	2018	2017
Operating activities:		
Net income	\$96,066	\$44,314
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	37,567	33,158
Amortization of deferred commissions costs	24,275	—
Amortization of debt issuance costs	436	1,487
Stock-based compensation expense	21,640	19,460
Deferred income tax expense, net	4,291	3,434
Bad debt expense	2,857	2,349
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(5,089)	(5,177)
Prepaid expenses and other current assets	(17,655)	(7,887)
Deferred commissions	(29,554)	—
Deposits and other assets	(1,444)	(103)
Accounts payable and other liabilities	(16,619)	605
Deferred revenue	2,546	3,723
Net cash provided by operating activities	119,317	95,363
Investing activities:		
Purchases of property and equipment and other assets	(15,851)	(12,674)
Cash paid for acquisitions, net of cash acquired	(340,074)	(45,068)
Net cash used in investing activities	(355,925)	(57,742)
Financing activities:		
Payments of long-term debt	—	(35,000)
Repurchase of restricted stock to satisfy tax withholding obligations	(22,394)	(13,456)
Proceeds from exercise of stock options and employee stock purchase plan	14,214	7,683
Net cash used in financing activities	(8,180)	(40,773)
Effect of foreign currency exchange rates on cash and cash equivalents	(397)	567
Net (decrease) in cash and cash equivalents	(245,185)	(2,585)
Cash and cash equivalents at the beginning of period	1,211,463	567,223
Cash and cash equivalents at the end of period	\$966,278	\$564,638
Supplemental cash flow disclosures:		
Interest paid	\$381	\$3,890
Income taxes paid	24,776	26,241
Supplemental non-cash investing and financing activities:		
Stock issued in connection with acquisition - ForRent	\$36,366	\$—
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 also 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 June 30, 2018 and December 31, 2017, the results of its operations for the three and six months ended June 30, 2018 and 2017, its comprehensive income for the three and six months ended June 30, 2018 and 2017, its changes in stockholders' equity for the six months ended June 30, 2018 and its cash flows for the six months ended June 30, 2018 and 2017. 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, 2017.

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, intangible assets and deferred commissions, 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 (“ARS”), accounting for business combinations and loss 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 revenues and expenses. Actual results could differ from these estimates.

Revenue Recognition

Subsequent to the Adoption of Accounting Standards Codification Revenue from Contracts with Customers ("ASC 606") on January 1, 2018

The Company derives revenues primarily by (i) providing access to its proprietary database of commercial real estate information and (ii) providing an online marketplace for professional property management companies, property owners, brokers, and landlords typically through a fixed monthly fee for its subscription-based services. The Company's subscription-based services consist primarily of information, analytics and online marketplace services offered over the Internet to commercial real estate industry and related professionals. Subscription contract rates are 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

COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

advertises and the prominence and placement of a client's advertised properties in the search results. A majority of the subscription-based license agreements have a term of one year and renew automatically.

The Company analyzes contracts to determine the appropriate revenue recognition using the following steps: (i) identification of contracts with customers, (ii) identification of distinct performance obligations in the contract, (iii) determination of contract transaction price, (iv) allocation of contract transaction price to the performance obligations and (v) determination of revenue recognition based on timing of satisfaction of the performance obligation(s).

The Company recognizes revenues upon the satisfaction of its performance obligation(s) (upon transfer of control of promised services to its customers) in an amount that reflects the consideration to which it expects to be entitled to in exchange for those services. Revenues from subscription-based services are recognized on a straight-line basis over the term of the agreement.

The Company's contracts with customers often include promises to transfer multiple services. For these contracts, the Company accounts for individual performance obligations separately if they are distinct. Determining whether services are considered distinct performance obligations may require significant judgment. Judgment is required to determine the standalone selling price ("SSP") for each distinct performance obligation. In instances where SSP is not directly observable, such as when the Company does not sell the service separately, the Company determines the SSP using information that may include market conditions and other observable inputs.

Deferred revenue results from amounts billed in advance to customers or cash received from customers in advance of the sale of subscription licenses and is recognized over the term of the license agreement.

Contract assets are generated when contractual billing schedules differ from revenue recognition timing. Contract assets represent a conditional right to consideration for satisfied performance obligations that become a billed receivable when the conditions are satisfied.

Certain sales commissions are considered incremental and recoverable costs of obtaining a contract with a customer. Sales commissions incurred for obtaining new contracts are deferred and then amortized as selling and marketing expenses on a straight-line basis over a period of benefit that the Company has determined to be three years. The three-year amortization period was determined based on several factors, including the nature of the technology and proprietary data underlying the services being purchased, customer contract renewal rates, and industry competition. Certain commissions costs are not capitalized as they do not represent incremental costs of obtaining a contract. See Note 3 for further discussion on the impact of the adoption of ASC 606.

For details about the Company's revenue recognition policy prior to the adoption of ASC 606, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Cost of Revenues

Cost of revenues principally consists of salaries, benefits, bonuses and stock-based compensation expenses for the Company's researchers who collect and analyze the commercial real estate data that is the basis for the Company's information, analytics and online marketplaces. Additionally, cost of revenues includes the cost of data from third-party data sources, credit card and other transactions fees relating to processing customer transactions, which are expensed as incurred, and the amortization of acquired trade names and other intangible assets and database

technology.

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 \$47 million and \$38 million for the three months ended June 30, 2018 and 2017, respectively. Advertising costs were approximately \$70 million and \$62 million for the six months ended June 30, 2018 and 2017, respectively.

COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

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. Currency gains and losses on the translation of intercompany loans made to foreign subsidiaries that are of a long-term investment nature are also 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 six months ended June 30, 2018 and 2017.

Accumulated Other Comprehensive Loss

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

	June 30, 2018	December 31, 2017
Foreign currency translation adjustment	\$(9,398)	\$ (8,290)
Accumulated net unrealized loss on investments, net of tax	(730)	(730)
Total accumulated other comprehensive loss	\$(10,128)	\$ (9,020)

There were no amounts reclassified out of accumulated other comprehensive loss to the condensed consolidated statements of operations for the three and six months ended June 30, 2018 and 2017. The foreign currency translation adjustment includes intra-entity foreign currency transactions that are of a long-term investment nature.

Income Taxes

Deferred income taxes result from temporary differences between the tax basis of assets and liabilities and the basis reported in the Company's consolidated financial statements. Deferred tax liabilities and assets are determined based on the difference between the financial statement and the tax basis of assets and liabilities using enacted rates in effect during the year in which the Company expects differences to reverse. Valuation allowances are provided against assets, including net operating losses, if the Company anticipates that some or all of an asset may not be realized through future taxable earnings or implementation of tax planning strategies. Interest and penalties related to income tax matters are recognized in income tax expense. See Note 10 for additional information regarding income taxes.

Net Income Per Share

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

COSTAR GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

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

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
Numerator:				
Net income	\$43,835	\$22,184	\$96,066	\$44,314
Denominator:				
Denominator for basic net income per share — weighted-average outstanding shares	36,073	32,406	35,983	32,341
Effect of dilutive securities:				
Stock options and restricted stock awards	377	333	417	310
Denominator for diluted net income per share — weighted-average outstanding shares	36,450	32,739	36,400	32,651
Net income per share — basic	\$1.22	\$0.68	\$2.67	\$1.37
Net income per share — diluted	\$1.20	\$0.68	\$2.64	\$1.36

Stock options to purchase approximately 83,000 and 96,000 shares that were outstanding for the three months ended June 30, 2018 and 2017, respectively, were not included in the computation of diluted net income per share because the inclusion of the potentially dilutive common shares would have an anti-dilutive effect. Stock options to purchase approximately 83,000 and 174,000 shares that were outstanding for the six months ended June 30, 2018 and 2017, respectively, were not included in the computation of diluted net income 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, market 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 June 30, 2018		Six Months Ended June 30, 2017	
Performance-based restricted stock awards				