

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

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934
For The Quarter Ended March 31, 2006

OR

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

HouseValues, Inc.

(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of

incorporation or organization)

11332 NE 122nd Way, Kirkland, WA 98034

(Address of principal executive offices, including zip code)

(425) 952-5500

(Registrant's telephone number, including area code)

91-1982679
(IRS Employer

Identification No.)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of April 19, 2006, there were outstanding 25,888,175 shares of the registrant's common stock, \$0.001 par value, which is the only class of common stock of the registrant.

Table of Contents

HOUSEVALUES, INC.

FORM 10-Q

Index

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Condensed Consolidated Financial Statements (unaudited)	
<u>Condensed Consolidated Statements of Income for the three months ended March 31, 2006 and 2005</u>	3
<u>Condensed Consolidated Balance Sheets as of March 31, 2006 and December 31, 2005</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2006 and 2005</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	18
Item 4. <u>Controls and Procedures</u>	19
PART II. OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	19
Item 1A. <u>Risk Factors</u>	19
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
Item 6. <u>Exhibits</u>	30
<u>SIGNATURE</u>	31

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

	Three months ended March 31,	
	2006	2005
Revenues	\$ 26,871	\$ 17,619
Expenses:		
Sales and marketing (includes share-based compensation expense of \$368 and \$66)	16,275	8,688
Technology and product development (includes share-based compensation expense of \$163 and \$57)	3,611	1,396
General and administrative (includes share-based compensation expense of \$521 and \$174)	3,750	2,839
Depreciation and amortization of property and equipment (1)	1,014	354
Amortization of intangible assets	401	152
Total expenses	25,051	13,429
Income from operations	1,820	4,190
Interest income, net	604	318
Income before income tax expense	2,424	4,508
Income tax expense	654	1,578
Net income	\$ 1,770	\$ 2,930
Net income per share:		
Basic	\$ 0.07	\$ 0.12
Diluted	\$ 0.06	\$ 0.11

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

	2005	2004
Technology and product development	\$ 522	\$ 113
General and administrative	492	241
	\$ 1,014	\$ 354

See accompanying notes to condensed consolidated financial statements.

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

	March 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 54,258	\$ 59,234
Short-term investments	30,575	25,640
Accounts receivable, net of allowance of \$234 and \$242	541	577
Prepaid expenses and other assets	1,858	1,700
Deferred income taxes	714	258
Prepaid income taxes	819	997
Other current assets	129	579
Total current assets	88,894	88,985
Property and equipment, net of accumulated depreciation of \$4,702 and \$3,689	11,925	11,118
Goodwill	6,877	6,227
Intangible assets, net of accumulated amortization of \$2,404 and \$2,003	4,455	4,853
Other noncurrent assets	409	408
Total assets	\$ 112,560	\$ 111,591
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 1,340	\$ 1,030
Accrued compensation and benefits	3,665	4,236
Accrued expenses and other current liabilities	4,648	6,529
Deferred rent, current portion	289	289
Deferred revenue	1,655	1,694
Total current liabilities	11,597	13,778
Deferred income taxes	773	726
Deferred rent, less current portion	1,349	1,423
Note payable	1,644	1,600
Total liabilities	15,363	17,527
Shareholders' equity:		
Common stock, par value \$0.001 per share, stated at amounts paid in; authorized 120,000,000 shares; issued and outstanding 25,852,075 and 25,783,980 shares at March 31, 2006 and December 31, 2005, respectively	69,851	71,385
Deferred stock-based compensation		(2,897)
Retained earnings	27,346	25,576
Total shareholders' equity	97,197	94,064
Total liabilities and shareholders' equity	\$ 112,560	\$ 111,591

See accompanying notes to condensed consolidated financial statements.

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

	Three months ended March 31,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 1,770	\$ 2,930
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	1,014	354
Amortization of intangible assets	401	152
Stock-based compensation	1,052	297
Deferred income tax benefit	(409)	(334)
Changes in certain assets and liabilities		
Accounts receivable	36	(265)
Prepaid expenses and other assets	(109)	233
Prepaid income taxes	209	
Other current assets	450	110
Accounts payable	28	44
Accrued compensation and benefits	(571)	(202)
Accrued expenses and other current liabilities	292	(42)
Deferred rent	(74)	65
Deferred revenue	(39)	126
Income taxes payable and other	44	896
Net cash provided by operating activities	4,094	4,364
Cash flows from investing activities:		
Purchases of short-term investments	(5,000)	(6,299)
Sales of short-term investments	65	4,300
Purchases of property and equipment	(3,748)	(1,476)
Additions to intangible assets and other	(41)	(41)
Earn-out payments related to the SOAR Solutions acquisition	(606)	
Net cash used in investing activities	(9,330)	(3,516)
Cash flows from financing activities:		
Proceeds from exercises of stock options and warrants	115	218
Tax benefit from exercises of stock options	145	
Issuance costs related to the sale of common stock		(618)
Net cash provided by (used in) financing activities	260	(400)
Net (decrease) increase in cash and cash equivalents	(4,976)	448
Cash and cash equivalents at beginning of period	59,234	57,562
Cash and cash equivalents at end of period	\$ 54,258	\$ 58,010

See accompanying notes to condensed consolidated financial statements.

Table of Contents

HouseValues, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands except per share amounts)

(unaudited)

Note 1: Summary of Significant Accounting Policies

Nature of Operations

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

Basis of Presentation

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

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the financial statements included in our 2005 Annual Report on Form 10-K. All adjustments necessary for the fair presentation of our results of operations, financial position and cash flows have been included and are of a normal, recurring nature. Operating results for the quarter ended March 31, 2006 are not necessarily indicative of results to be expected for a full year.

Use of Estimates

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

Reclassifications

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

Summary of significant accounting policies

The significant accounting policies used in the preparation of our consolidated financial statements are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. Updates to our significant accounting policies for 2006 are disclosed below.

Stock-based Compensation

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

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

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

stock account.

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

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

Table of Contents

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

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

Recent Accounting Pronouncements

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

Note 2: Acquisitions**The Loan Page**

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

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

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

	October 31, 2005 (Date of Acquisition)
Cash	\$ 171
Current assets	546
Restricted cash	330
Intangible asset - customer base	1,850
Intangible asset - developed technology	1,950
Goodwill	3,324
Current liabilities	(1,068)
Deferred income taxes, net	(119)
Note payable	(1,590)
	\$ 5,394

Table of Contents

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

	Three months ended
	March 31, 2005
Revenues	\$ 18,683
Net income	\$ 2,593
Net income per share basic	\$ 0.10
Net income per share diluted	\$ 0.10

Soar Solutions

In June 2003, we acquired the stock of Soar Solutions, Inc., a real-estate services company, in exchange for \$1,510 in cash, 200,000 shares of unvested restricted common stock and an earn-out arrangement equal to 5% of specified customer receipts through March 2006. As of March 31, 2006, additional amounts of approximately \$3,532 were earned under the earn-out arrangement. As contingent consideration was earned, the amounts increased the vendor agreements asset to its fair value and excess amounts were recorded as goodwill.

Mapping Software Technology

In December 2004, we acquired software from an individual who has become an employee of the company. The company paid \$38 in cash and issued 50,000 stock options, valued at \$410. The agreement also provided for additional payments of \$163 contingent upon certain events. As of March 31, 2006 all contingent consideration had been earned and paid. Including cash paid at acquisition, additional contingent consideration, options granted in connection with the acquisition and transaction expenses, the acquired asset was valued at approximately \$620 at March 31, 2006.

Note 3: Earnings per share

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

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

	Three months ended March 31,	
	2006	2005
Net income	\$ 1,770	\$ 2,930
Weighted average common shares outstanding	25,810	25,024
Dilutive effect of stock options	1,543	2,223
Diluted Shares	27,353	27,247
Basic earnings per share	\$ 0.07	\$ 0.12
Diluted earnings per share	\$ 0.06	\$ 0.11
Antidilutive stock options	1,696	126

Note 4: Income Taxes

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

Our effective tax rate was 27% for the quarter ended March 31, 2006, compared to 35% for the quarter ended March 31, 2005 and 33% for all of 2005. Our effective tax rate decreased due to the increase in our tax-exempt interest income in total and relative to operating earnings.

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

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

	Three months ended March 31,	
	2006	2005
Real estate product revenues	\$ 23,236	\$ 17,170
Mortgage product revenues	3,635	449
Total revenue	\$ 26,871	\$ 17,619

Note 6: Stock-based compensation plans

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

Determining Fair Value under FAS 123R

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

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

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

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

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

The value of each employee option granted during the quarters ended March 31, 2006 and 2005 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three months ended March 31,	
	2006	2005
Expected life (in years)	3.0	4.0
Weighted average expected volatility	90%	100%
Weighted average risk-free interest rate	4.55%	4.36%
Expected dividend yield	0%	0%
Weighted average fair value	\$ 8.51	\$ 9.34

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

The following table summarizes stock-based compensation expense related to stock-based awards under FAS 123R for the three months ended March 31, 2006:

	Three months ended	
	March 31, 2006	
Total cost of share-based payment plans	\$	1,102
Amounts capitalized in internally developed software		50
Amounts charged against income, before income tax benefit	\$	1,052
Amount of related income tax benefit recognized in income	\$	271
Amounts recognized in income for amounts previously capitalized in fixed assets	\$	1

As of March 31, 2006, we had \$15,100 of unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans. We expect to recognize this cost over a weighted average period of 1.62 years.

The following table presents the impact of our adoption of FAS 123R on selected line items from our consolidated financial statements for the three months ended March 31, 2006:

	Three months ended March 31, 2006	
	As Reported	If Reported
	Following FAS 123R	Following APB 25
Condensed consolidated statement of operations:		
Income before income tax expense	\$ 2,424	\$ 3,207
Net income	1,770	2,347
Net income per share		
Basic	0.07	0.09
Diluted	0.06	0.09
Condensed consolidated statement of cash flows:		
Net cash provided by operating activities	4,094	4,239
Net cash provided by financing activities	\$ 260	\$ 115

Stock Option Activity

At March 31, 2006, we had two stock option plans. Additional information regarding these plans is disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005. As of March 31, 2006, we have reserved an additional 1.7 million shares for future issuance under our stock option plans. We issue new shares for option exercises.

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

Options	Weighted	Weighted	Aggregate
	Average	Average	Intrinsic
	Exercise	Remaining	Value
	Price	Contractual	

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

				Life	
Outstanding at December 31, 2005	4,102,102	\$ 6.93			
Options granted	178,800	14.35			
Options exercised	(68,095)	1.69			
Options canceled	(214,864)	9.85			
Options expired	(62)	2.20			
Outstanding at March 31, 2006	3,997,881	\$ 7.19	8.0 years		\$ 13,477
Exercisable at March 31, 2006	1,580,654	\$ 3.08	6.5 years		\$ 8,730

Table of Contents

At December 31, 2005, 1,391,616 options were exercisable at a weighted-average exercise price of \$2.72. The aggregate intrinsic value of options outstanding at March 31, 2006 and 2005 is calculated as the difference between the market price of the underlying common stock and the exercise price of the options for the options with exercise prices that were lower than the closing market price of our common stock at period end. The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was \$632 and \$1,854, determined as of the date of exercise. The total fair value of options that vested during the quarters ended March 31, 2006 and 2005 was \$864 and \$276. The total fair value of options that were forfeited during the quarters ended March 31, 2006 was \$1,239 and \$357, respectively.

Pro Forma Information under FAS 123 and APB 25

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

	Three months ended	
	March 31,	
	2006	2005
Net income, as reported	\$ 1,770	\$ 2,930
Add: stock-based compensation included in net income, net of tax	781	203
Deduct: total stock-based compensation determined under fair value based method for all awards, net of tax	(781)	(311)
Net income (pro forma for 2005)	\$ 1,770	\$ 2,822
Basic net income per share:		
As reported	\$ 0.07	\$ 0.12
Pro forma (for 2005)		\$ 0.11
Diluted net income loss per share:		
As reported	\$ 0.06	\$ 0.11
Pro forma (for 2005)		\$ 0.11

Note 7: B&O Tax Audit Settlement

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

Note 8: Supplemental Disclosure of Cash Flow Information

	Three months ended	
	March 31,	
	2006	2005
Cash paid during the period for income taxes, net of refunds received	\$ 708	\$ 1,018
Noncash investing and financing activities:		
Accrued earn-out payments in connection with acquisitions	\$ 681	\$ 381
Accrued invoices for property and equipment	\$ 471	\$ 176

Table of Contents

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

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

Overview

The first quarter of 2006 represents our 20th consecutive quarter of profitable operations. We continued to see growth in our revenue during the first quarter of 2006. Revenue was a record \$26.9 million, an increase of 53% compared to the first quarter of 2005 and 7% compared to the fourth quarter of 2005. Net income decreased 40% to \$1.8 million, when compared to the same period last year and decreased 56% compared to the fourth quarter of 2005 as we continue to invest in building our business. Fourth quarter 2005 results also include a reduction to our B&O tax accrual of \$1.8 due to the settlement of our Washington State B&O tax audit.

Launch of Mortgage Service Offering: During the second quarter of 2005 we announced a new marketing service specifically designed to help mortgage professionals generate more business by enabling them to build relationships with both prospective home buyers and local real estate agents. This integrated service offering includes exclusive home buyer leads, a proprietary mortgage customer relationship management tool that enables communication with prospective customers, past clients and local real estate professionals, marketing materials and dedicated training and account management support. We generate revenue from this service offering by charging mortgage customers a monthly fixed fee. We saw this business continue to grow in 2006.

Launch of HomePages Web Site: On October 11, 2005, we announced the launch of HomePages, an Internet web site that aids consumers in the home buying and selling process by combining nationwide home listings, high resolution aerial photos, and detailed neighborhood information to provide a comprehensive view of each home and neighborhood. The site features homes for sale and displays detailed information on the nearby schools, parks, shops and local services. HomePages also provides home owners with information on recently sold homes in their neighborhood as well as the ability to get a local expert's estimate of their home's value.

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

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

Acquisition of The Loan Page: On October 31, 2005 we completed our acquisition of The Loan Page, Inc. The company was purchased for approximately \$5.2 million in cash and \$1.6 million in assumed debt. Additionally, we incurred \$0.1 million in transaction costs. The Loan Page generates and markets mortgage leads to mortgage lenders, including some of the nation's largest banking and lending institutions.

Effective with the acquisition of The Loan Page, we are exploring alternatives to reduce our reliance on affiliate network lead sourcing for this product. We have begun direct advertising campaigns to drive consumer traffic directly to The Loan Page. Also, starting in March, we enabled a small portion of the consumers visiting HouseValues.com to indicate if their interest was financing-related. We believe that the high-quality, low-cost mortgage leads that were generated as a result of these efforts suggest a significantly larger opportunity to improve overall traffic monetization while also enhancing lead quality. The three months ending March 31, 2006 included our first full quarter of revenue from The Loan Page.

We also began to transition some mortgage customers from our JustListed Connect product to The Loan Page product during the quarter while continuing to offer both products. This product transition is intended to increase average times sold

Table of Contents

for The Loan Page's semi-exclusive lead generation platform, to enhance mortgage customer retention, and to make additional JustListed inventory available for real estate customers.

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

Results of Operations*Revenues*

	Three months ended March 31,	
	2006	2005
Revenues	\$ 26,871	\$ 17,619

Revenues for the first quarter of 2006 increased 53% over the same quarter in 2005 due to the growth of our real estate business and the 2005 launch of our mortgage business. Our real estate revenues increased 35% year over year due to the growth of our JustListed and HouseValues products and the 2006 addition of our HomePages service. Average core real estate customer count increased 29% and our average real estate revenue per customer increased 7%. We officially announced our mortgage service in June 2005 and acquired The Loan Page in October 2005.

Revenue in the first quarter of 2006 increased 7% over the fourth quarter of 2005. Real estate revenues increased 6% primarily due to the addition of our HomePages service. We experienced a 3% increase in average real estate core customer count and 4% increase in average real estate revenue per customer during the first quarter. Mortgage revenue increased 8% primarily due to the inclusion of our first full quarter of The Loan Page revenues. More information about the sequential change in real estate revenue and customers is included in the Key Operational Metrics Real Estate Products section of Management's Discussion and Analysis.

Sales and Marketing

	Three months ended March 31,			
	2006	% of Revenue	2005	% of Revenue
Sales and marketing expense before stock-based compensation	\$ 15,907	59%	\$ 8,622	49%
Stock-based compensation	368	2%	66	
Total sales and marketing expense	\$ 16,275	61%	\$ 8,688	49%

Sales and marketing expense increased in total and as a percentage of revenue primarily due to expenses related to investment in new business initiatives, an increase in lead generation costs resulting from greater customer demand and increased cost of leads. These media costs, as a percentage of revenue for HouseValues and Just Listed, were higher than the record low levels seen in the first half of 2005, yet improved compared to levels seen in 2004. Sales and marketing expenses related to HomePages and The Loan Page exceeded their revenue contribution in the first quarter reflecting new advertising to expand consumer awareness and the hiring of personnel to drive these business initiatives.

First quarter 2006 sales and marketing expense increased \$2.6 million over the fourth quarter of 2005 and increased as a percentage of revenue from 54% to 61%. Advertising costs increased in total dollars and as a percent of revenues as we increased our advertising spend from our seasonal low spend in the fourth quarter of 2005 and focused on building our HomePages and mortgage products. Payroll costs increased due to changes in our personnel mix and the expensing of stock options.

As of March 31, 2006, we had increased lead delivery to customers through the combination of seasonally stronger consumer response rates and higher media spending. As a result, we expect sales and marketing costs in the second quarter of 2006 to be slightly lower than in the first quarter in both absolute dollars and percentage of revenue terms. Looking forward, we plan to continue making significant marketing investments in our mortgage and HomePages through the second quarter of 2006.

Table of Contents*Technology and Product Development*

	2006	Three months ended March 31, % of Revenue	2005	% of Revenue
Technology and product development expense before stock-based compensation	\$ 3,448	13%	\$ 1,339	8%
Stock-based compensation	163		57	
Total technology and product development expense	\$ 3,611	13%	\$ 1,396	8%

Technology and product development expense increased \$2.2 million and as a percentage of revenue for the quarter ended March 31, 2006 as compared to the same period in 2005, primarily due to payroll and related expenses, including stock-based compensation, and contractor expense. Headcount nearly doubled as we continued to maintain and improve our existing services, features and infrastructure for our increasing customer base. This increase was partially offset by higher capitalized labor.

When comparing the first quarter of 2006 with the fourth quarter of 2005, technology and product development expense increased about \$0.9 million and increased as a percentage of revenue from 10% to 13% quarter over quarter, as a result of increased payroll and related expenses and contractor expense.

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

General and Administrative

	2006	Three months ended March 31, % of Revenue	2005	% of Revenue
General and administrative expense before stock-based compensation	\$ 3,229	12%	\$ 2,665	15%
Stock-based compensation	521	2%	174	1%
Total general and administrative expense	\$ 3,750	14%	\$ 2,839	16%

General and administrative expenses increased in total dollars but decreased as a percentage of revenues for the quarter ended March 31, 2006 when compared to the same period last year, primarily due to several components:

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

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

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

These increases were partially offset by decreases to our state and local tax expense. In December 2005, we reached an agreement with the Washington State Department of Revenue to settle a business and occupation tax audit covering the period from January 2001 through September 2005 for a total of \$675. Through September 2005, we had accrued \$2,468 for the estimated cost of the assessment, which was our best estimate of our ultimate liability based on the preliminary assessment and subsequent negotiations with the Department of Revenue. As a

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

result, in 2005, we reduced our accrual to the settlement amount and recorded \$1.8 million as a reduction of general and administrative expenses. Additionally we have adjusted our accrual percentage going forward.

First quarter 2006 general and administrative expenses increased \$1.3 million from the fourth quarter of 2005 primarily due to the \$1.8 million reduction of state and business taxes in 2005 discussed above. Without this adjustment we would have seen a decrease in general and administrative expenses primarily due to decreases in accounting fees, recruiting expense and payroll expense partially offset by increased stock-based compensation.

Table of Contents

Depreciation and Amortization of Property and Equipment

Depreciation and amortization of property and equipment increased year-over-year primarily due to additional depreciation expense on workstations and equipment purchased to accommodate our increased headcount and additional investment in our technological infrastructure.

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

Amortization of Intangible Assets

Amortization of intangible assets increased for the quarter ended March 31, 2006, when compared to the same period in 2005. The increase in amortization expense resulted primarily from additions to our intangible assets obtained as part of The Loan Page acquisition in the fourth quarter of 2005.

Interest Income

Interest income increased for the quarter ended March 31, 2006, when compared to the same period in 2005 due to larger cash and investment balances in 2006 and as well as increased rates of return on investments. At March 31, 2006, we held \$84.8 million in cash, cash equivalents and short-term investments, compared to \$77.3 million at March 31, 2005. Cash, cash equivalents and short-term investments increased primarily due to cash generated from operations, net of investments in capital assets.

Income Taxes

First quarter 2006 income tax expense decreased over the same period last year as a result of lower pretax income and a lower effective tax rate. Our effective tax rate decreased due to the increase in our tax-exempt interest income in total and relative to operating earnings.

We anticipate our effective tax rate will continue at approximately 27% for the balance of the year.

Critical Accounting Policies and Estimates

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

Quarterly Consolidated Statements of Income and Operational Data

The following tables present the unaudited consolidated statements of income data for the five quarters ended March 31, 2006 in dollars and as a percentage of revenues. This quarterly information has been prepared on the same basis as our audited consolidated financial statements and, in the opinion of our management, reflects all adjustments necessary for a fair representation of the information for the periods presented. This data should be read in conjunction with our audited consolidated financial statements and the related notes included in our 2005 Annual Report on Form 10-K. Operating results for any quarter apply to that quarter only and are not necessarily indicative of results for any future period.

Table of Contents

	Mar. 31, 2005	June 30, 2005	Sept. 30, 2005	Dec. 31, 2005	Mar. 31, 2006
Consolidated Statements of Income Data, in thousands:					
Revenues	\$ 17,619	\$ 20,577	\$ 23,337	\$ 25,177	\$ 26,871
Expenses:					
Sales and marketing	8,688	10,338	11,556	13,669	16,275
Technology and product development	1,396	1,739	1,823	2,692	3,611
General and administrative	2,839	3,107	3,375	2,465	3,750
Depreciation and amortization of property and equipment	354	402	506	629	1,014
Amortization of intangible assets	152	151	151	322	401
Total expenses	13,429	15,737	17,411	19,777	25,051
Income from operations	4,190	4,840	5,926	5,400	1,820
Interest income	318	486	491	579	604
Income before income tax expense	4,508	5,326	6,417	5,979	2,424
Income tax expense	1,578	1,618	2,086	1,965	654
Net income	\$ 2,930	\$ 3,708	\$ 4,331	\$ 4,014	\$ 1,770
Reconciliation of GAAP Measurement to Adjusted EBITDA:					
Net income	\$ 2,930	\$ 3,708	\$ 4,331	\$ 4,014	\$ 1,770
Less: Interest income	(318)	(486)	(491)	(579)	(604)
Add:					
Depreciation and amortization of property and equipment	354	402	506	629	1,014
Amortization of intangible assets	152	151	151	322	401
Stock-based compensation	297	258	274	273	1,052
Income tax expense	1,578	1,618	2,086	1,965	654
Adjusted EBITDA	\$ 4,993	\$ 5,651	\$ 6,857	\$ 6,624	\$ 4,287
Consolidated Statements of Income Data as a Percentage of Revenue:					
Revenues	100%	100%	100%	100%	100%
Expenses:					
Sales and marketing	49	50	49	54	61
Technology and product development	8	8	8	11	13
General and administrative	16	15	14	10	14
Depreciation and amortization of property and equipment	2	2	2	2	4
Amortization of intangible assets	1	1	1	1	1
Total expenses	76	76	74	78	93
Income from operations	24	24	26	22	7
Interest income	2	2	2	2	2
Income before income tax expense	26	26	28	24	9
Income tax expense	9	8	9	8	2
Net income	17%	18%	19%	16%	7%
Adjusted EBITDA	28%	27%	29%	26%	16%

Adjusted EBITDA is a non GAAP financial measure provided as a complement to results provided in accordance with accounting principles generally accepted in the United States of America (GAAP). The term Adjusted EBITDA refers to a financial measure that we define as

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

earnings before net interest, income taxes, depreciation, amortization and share-based compensation. Adjusted EBITDA is not a substitute for measures determined in accordance with GAAP, and may not be comparable to measures reported by other companies. We believe Adjusted EBITDA provides relevant and useful information to our investors as this measure is an integral part of our internal management reporting and planning process and is the primary measure used by our management to evaluate the operating performance of our operations. The components of Adjusted EBITDA include the key revenue and expense items for which our operating managers are

Table of Contents

responsible and upon which we evaluate their performance, and we also use Adjusted EBITDA for planning purposes and in presentations to our board of directors.

Key Operational Metrics Real Estate Products

Our increase in mortgage customers over the past year and the shift in our mix of mortgage customers to include many enterprise level clients, has made the metrics shown below less meaningful for the mortgage business. As a result, we have excluded our mortgage services from the following metrics to ensure that these metrics provide meaningful and consistent insight into our business. Had we included our mortgage services, average revenue per customer would have been \$512, ending core customers 16,769 and churn 7.0% for the first quarter of 2006. The following table presents operational data related to our real estate products for the five quarters ended March 31, 2006:

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

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

Our core real estate customer count increased by 854 customers during the first quarter of 2006, compared to a net increase of 3 customers in the fourth quarter of 2005. Historically, customer growth has been the strongest in the first and third quarters. Ending core real estate customers increased 23% in the first quarter of 2006 compared to the first quarter of 2005.

Average monthly churn for our real estate business was 6.6% for the first quarter of 2006, down from 7.0% in the fourth quarter of 2005. Monthly churn of 6.6% equates to 93% monthly retention which represents a 44% annualized retention rate. While we expect to experience fluctuations in our churn rate from quarter to quarter, we continue to believe that our monthly churn rate will remain within the 6%-7% range.

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

Average monthly revenue per real estate customer for the first quarter of 2006 increased 4% compared to the fourth quarter of 2005. This growth is primarily due to sales of our HomePages Showcase product to our existing customers. Average revenue per customer will fluctuate from quarter to quarter, however it may decline as our business matures or if we are forced to discount our prices in response to competition or in an effort to accelerate our growth.

Table of Contents**Liquidity and Capital Resources**

The following table presents summary cash flow data:

	Three months Ended March 31,	
	2006	2005
	(dollars in thousands)	
Cash provided by operating activities	\$ 4,094	\$ 4,364
Cash used in investing activities	(9,330)	(3,516)
Cash provided by (used in) financing activities	260	(400)

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

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

Operating Activities

Net cash provided by operating activities primarily consists of net income adjusted for certain non-cash items, including depreciation, amortization, stock-based compensation, deferred income taxes and the effect of changes in working capital. Net cash provided by operating activities for the first quarter of 2006 declined 6% from the same period in 2005. Our decrease in net income was partially offset by increases in non-cash items.

Investing Activities

Cash used in investing activities for the three months ended March 31, 2006 increased by \$5.8 million compared to the same period last year. During the first three months of 2006, capital expenditures increased and our sales of short-term investments decreased when compared to the same period last year. Our capital expenditures were generally for the purchase of office equipment and leasehold improvements at our new Yakima location as well as investments in our customer-facing infrastructure and the development costs related to new products and features.

Financing Activities

Cash used in financing activities for the first quarter of 2005 included \$0.6 million in issuance costs related to the public sale of our common stock in December 2004.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued Statement No. 123 (revised 2004), *Share-Based Payments* (FAS 123R). FAS 123R requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments, such as stock options granted to employees. We adopted FAS 123R during the first quarter of 2006. We have elected to apply FAS 123R on a modified prospective method. Under this method, we apply the fair value method in 2006 and do not restate prior periods. Further, compensation expense for existing grants will be recorded for the unvested portion of the fair value compensation expense of those grants over the remaining vesting periods. We believe that the compensation expense we recognize in 2006 will increase substantially from what we have historically disclosed as proforma compensation expense under the fair value method, due to the increased number of option grants issued and the increase in the average option fair value. Also, FAS 123R requires us to reflect the tax savings resulting from tax deductions in excess of expense reflected in our financial statements as a financing cash flow, which may have a material impact on our future reported cash flows from operating activities.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

less.

Table of Contents

Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our Company's management, including the Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e)) under the Securities Exchange Act of 1934, as amended. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2006.

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

Our current and potential competitors include:

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

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

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

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

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

Table of Contents

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

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

devote greater resources to marketing or selling their services;

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

withstand price competition more successfully than we can;

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

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

more effectively negotiate third-party arrangements; and

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

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

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

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

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

Any failure to retain customers could harm our business.

Our ability to retain customers will depend, in part, on our ability to generate leads from prospective home buyers, sellers and mortgage consumers in quantities demanded by our customers. In addition, our success will depend on our ability to enhance our existing services, develop new technologies that address the increasingly sophisticated and varied needs of customers, respond to technological advances and emerging industry standards and practices in a timely manner and on a cost effective basis. Our real estate customer contracts and many of our

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

mortgage customer contracts require us to deliver a guaranteed minimum number of leads per month to each customer. We occasionally fail to deliver the number of leads we are required to deliver to a customer in a given month. For example, during the quarter ended March 31, 2006, we were unable to deliver approximately 2.2% of our total guaranteed lead obligations to customers. Our estimated obligation for underdelivered leads at March 31, 2006 was approximately \$0.1 million. If we regularly fail to deliver the number of leads we are required to deliver to a customer, that customer will likely become dissatisfied with our services. In addition, if we do not maintain adequate technical support levels, or continue to improve the ease of use, functionality and features of our Market Leader prospect management system, customer coaching and training offerings, or if customers are dissatisfied with the quality of the leads that we provide, our customer may choose not to extend their contracts for our services.

Table of Contents

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

Our customer contracts typically have an initial term of twelve months, with automatic one-month extensions unless terminated by either party. Some customers have decided not to extend their contracts due to their inability to convert the leads we have provided into closed transactions or dissatisfaction with our services. For example, our real estate average monthly churn rate for the quarter ended March 31, 2006 was 6.6%, compared to 7.0% for the quarter ended December 31, 2005. We calculate average monthly churn by dividing the number of core customers who cancel during the quarter by the average core customers in the quarter, divided by the number of months in the quarter.

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

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

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

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

We have experienced rapid growth in our revenues, expenses and employee headcount. In addition to adding a number of senior individuals to our management team, our overall employee base has grown from 266 employees as of December 31, 2004 to 526 employees as of March 31, 2006. Further, we have recently opened a new facility in Yakima, Washington, which is our first location other than our corporate headquarter. This expansion has placed, and is expected to continue to place, a significant strain on our managerial, operational and financial resources.

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

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

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

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

Table of Contents

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

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

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

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

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

Risks Associated with Television Advertising. Television advertising rates depend on a number of factors, including the strength of the national economy and regional economies and the strength of certain industries that advertise frequently. Advertising rates are also subject to cyclical and seasonal fluctuations. If television advertising prices increase significantly, in the absence of more efficient ways to generate leads, our marketing expenses will also increase, which would harm our results of operations.

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

Our business is governed by various federal, state and local laws and regulations governing the real estate industry, including the Real Estate Settlement Procedures Act (RESPA), the Fair Housing Act, state and local real estate and mortgage broker licensing laws, federal and state laws prohibiting unfair and deceptive acts and practices, and federal and state advertising laws. We may not have always been and may not always be in compliance with each of these requirements. Failure to comply with these requirements may result in, among other things, revocation of required licenses, indemnification liability to contract counterparties, class action lawsuits, administrative enforcement actions and civil and criminal liability.

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

We regard substantial elements of our web sites, software tools and applications and underlying technology as proprietary. Despite our precautionary measures, third parties may copy or otherwise obtain and use our proprietary information without authorization or may develop similar technology independently. We may not be able to detect such infringements or may lose any competitive advantage in the market before we do so. In addition, competitors may design around our technology or develop competing technologies substantially similar to ours. Unauthorized parties may attempt to disclose, obtain or use our technology. Our precautions may not prevent misappropriation of our intellectual property, particularly in foreign countries where laws or law enforcement practices may not protect our proprietary rights as fully as in the United States. Any legal action that we may bring to protect our proprietary information could be unsuccessful and expensive and could divert management's attention from other business concerns. Legal standards relating to the validity, enforceability and scope of protection of proprietary rights in Internet-related businesses are uncertain and evolving, and we cannot assure you of the future viability or value of any of our proprietary rights.

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

Through March 31, 2006, we have used approximately \$18.9 million of the proceeds to purchase property and equipment and intangible assets. The remaining proceeds have been invested in money market funds and highly liquid, short-term, adjustable-rate insured municipal notes. Our current and planned use of the proceeds does not represent a material change from the use of proceeds described in the prospectus relating to the Registration Statement.

Table of Contents

Item 6. Exhibits

Exhibit Number	Description of Document
10.1*	Description of nonqualified stock option program for non-employee directors and description of 2006 executive officer salaries, incorporated by reference from the description contained in the Registrant's Form 8-K filed on February 10, 2006.
31.1	Certification of Ian Morris, Chief Executive Officer of HouseValues, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of Item 601 of Regulation S-K.
31.2	Certification of John Zdanowski, Chief Financial Officer of HouseValues, Inc., Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 of Item 601 of Regulation S-K.
32.1	Certification of Ian Morris, Chief Executive Officer of HouseValues, Inc. and John Zdanowski, Chief Financial Officer of HouseValues, Inc., Pursuant to 18 U.S.C. Section 1350 of Item 601 of Regulation S-K.

* Management contract or compensatory plan

Table of Contents

SIGNATURE

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

HOUSEVALUES, INC.

By: /s/ JOHN ZDANOWSKI
John Zdanowski

Authorized Officer and Principal Financial Officer

May 10, 2006