COSTAR GROUP INC
Form 10-Q
October 22, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from _____ to _____

Commission file number 0-24531

CoStar Group, Inc.
(Exact name of registrant as specified in its charter)

| Delaware | 52-2091509 |
| --- | --- |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Securities Exchange Act of 1934.

| | |
|---|---|
| Large accelerated filer o | Accelerated filer x |
| Non-accelerated filer o | Smaller reporting company o |
| (Do not check if a smaller reporting company) | |

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

As of October 15, 2010, there were 20,745,516 shares of the registrant's common stock outstanding.

COSTAR GROUP, INC.

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PART I — FINANCIAL INFORMATION

Item 1.Financial Statements

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Revenues | $57,144 | $53,590 | $168,075 | $155,024 |
| Cost of revenues | 20,762 | 19,149 | 62,322 | 52,787 |
| Gross margin | 36,382 | 34,441 | 105,753 | 102,237 |
| | | | | |
| Operating expenses: | | | | |
| Selling and marketing | 13,017 | 11,630 | 38,526 | 30,542 |
| Software development | 4,249 | 3,454 | 12,569 | 9,697 |
| General and administrative | 12,441 | 11,564 | 37,168 | 33,585 |
| Purchase amortization | 540 | 842 | 1,762 | 2,530 |
| | 30,247 | 27,490 | 90,025 | 76,354 |
| | | | | |
| Income from operations | 6,135 | 6,951 | 15,728 | 25,883 |
| Interest and other income, net | 156 | 263 | 590 | 1,027 |
| | | | | |
| Income before income taxes | 6,291 | 7,214 | 16,318 | 26,910 |
| Income tax expense, net | 2,909 | 2,889 | 6,796 | 11,863 |
| | | | | |
| Net income | $3,382 | $4,325 | $9,522 | $15,047 |
| | | | | |
| Net income per share ¾ basic | $0.17 | $0.22 | $0.47 | $0.77 |
| Net income per share ¾ diluted | $0.16 | $0.22 | $0.46 | $0.76 |
| | | | | |
| Weighted average outstanding shares ¾ basic | 20,328 | 19,868 | 20,309 | 19,628 |

| | | | | |
|---|---|---|---|---|
| Weighted average outstanding shares ¾ diluted | 20,688 | 20,084 | 20,677 | 19,749 |

See accompanying notes.

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

| ASSETS | September 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $195,358 | $205,786 |
| Short-term investments | 7,265 | 20,188 |
| Accounts receivable, less allowance for doubtful accounts of approximately $2,626 and $2,863 as of September 30, 2010 and December 31, 2009, respectively | 13,673 | 12,855 |
| Deferred income taxes, net | 4,463 | 3,450 |
| Prepaid expenses and other current assets | 5,718 | 5,128 |
| Total current assets | 226,477 | 247,407 |
| | | |
| Long-term investments | 29,349 | 29,724 |
| Deferred income taxes, net | 3,984 | 1,978 |
| Fixed assets, net | 64,973 | 19,162 |
| Goodwill | 80,134 | 80,321 |
| Intangibles and other assets, net | 19,965 | 23,390 |
| Deposits and other assets | 3,017 | 2,597 |
| Total assets | $427,899 | $404,579 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $1,893 | $3,667 |
| Accrued wages and commissions | 8,864 | 9,696 |
| Accrued expenses and deferred rent | 22,731 | 15,544 |
| Deferred revenue | 16,251 | 14,840 |
| Total current liabilities | 49,739 | 43,747 |
| | | |
| Income taxes payable | 1,882 | 1,826 |
| Total liabilities | 51,621 | 45,573 |
| | | |
| Total stockholders' equity | 376,278 | 359,006 |
| | | |
| Total liabilities and stockholders' equity | $427,899 | $404,579 |

See accompanying notes.

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2010 | 2009 |
| Operating activities: | | |
| Net income | $9,522 | $15,047 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 6,412 | 5,596 |
| Amortization | 3,849 | 5,146 |
| Fixed asset write-off | 319 | 587 |
| Excess tax benefit from stock options | (718) | ¾ |
| Stock-based compensation expense | 5,727 | 5,167 |
| Deferred income tax expense, net | (2,251) | (1,785) |
| Provision for losses on accounts receivable | 1,271 | 3,633 |
| Changes in operating assets and liabilities, net of acquisitions: | | |
| Accounts receivable | (2,129) | (2,276) |
| Prepaid expenses and other current assets | (588) | (504) |
| Deposits and other assets | (391) | (253) |
| Accounts payable and other liabilities | 4,625 | 2,497 |
| Deferred revenue | 1,447 | (1,041) |
| Net cash provided by operating activities | 27,095 | 31,814 |
| | | |
| Investing activities: | | |
| Sales of investments | 13,222 | 14,051 |
| Purchases of fixed assets and other assets | (53,112) | (5,835) |
| Acquisitions, net of cash acquired | ¾ | (392) |
| Net cash (used in) provided by investing activities | (39,890) | 7,824 |
| | | |
| Financing activities: | | |
| Excess tax benefit from stock options | 718 | ¾ |
| Repurchase of restricted stock to satisfy tax withholding obligations | (1,213) | (501) |
| Proceeds from exercise of stock options | 3,035 | 1,007 |
| Net cash provided by financing activities | 2,540 | 506 |
| | | |
| Effect of foreign currency exchange rates on cash and cash equivalents | (173) | 612 |
| Net (decrease) increase in cash and cash equivalents | (10,428) | 40,756 |
| Cash and cash equivalents at the beginning of period | 205,786 | 159,982 |
| Cash and cash equivalents at the end of period | $195,358 | $200,738 |

See accompanying notes.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## 1. ORGANIZATION

CoStar Group, Inc. (the "Company") has created a comprehensive, proprietary database of commercial real estate information covering the United States, as well as parts of the United Kingdom and France. Based on its unique database, the Company provides information, marketing and analytic services to the commercial real estate and related business community and operates within two operating segments, including U.S. and International. The Company's information, marketing and analytic services are typically distributed to its clients under subscription-based license agreements, which typically have a minimum term of one year and renew automatically.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

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

### Interim Financial Statements

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information. In the opinion of the Company's management, the financial statements reflect all adjustments necessary to present fairly the Company's financial position at September 30, 2010, the results of its operations for the three and nine months ended September 30, 2010 and 2009, and its cash flows for the nine months ended September 30, 2010 and 2009. These adjustments are of a normal recurring nature.

Certain notes and other information have been condensed or omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of future financial results.

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

### Foreign Currency Translation

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

currency exchange transactions for the three and nine months ended September 30, 2010 and 2009.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Comprehensive Income

The components of total comprehensive income were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| Net income | $3,382 | $4,325 | $9,522 | $15,047 |
| Foreign currency translation adjustment | 1,434 | (1,402) | (441) | 3,567 |
| Net unrealized gain (loss) on investments, net of tax | (41) | 115 | (77) | 2,635 |
| Total comprehensive income | $4,775 | $3,038 | $9,004 | $21,249 |

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

| | September 30, 2010 | December 31, 2009 |
|---|---|---|
| | (unaudited) | |
| Foreign currency translation adjustment | $(5,291) | $(4,850) |
| Accumulated net unrealized loss on investments, net of tax | (2,792) | (2,715) |
| Total accumulated other comprehensive loss | $(8,083) | $(7,565) |

Net Income Per Share

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

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Net Income Per Share — (Continued)

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | (unaudited) | | | |
| Net income | $3,382 | $4,325 | $9,522 | $15,047 |
| Denominator: | | | | |
| Denominator for basic net income per share ¾ weighted-average outstanding shares | 20,328 | 19,868 | 20,309 | 19,628 |
| Effect of dilutive securities: | | | | |
| Stock options and restricted stock | 360 | 216 | 368 | 121 |
| Denominator for diluted net income per share ¾ weighted-average outstanding shares | 20,688 | 20,084 | 20,677 | 19,749 |
| | | | | |
| Net income per share ¾ basic | $0.17 | $0.22 | $0.47 | $0.77 |
| Net income per share ¾ diluted | $0.16 | $0.22 | $0.46 | $0.76 |

Employee stock options with exercise prices greater than the average market price of the Company's common stock for the period were excluded from the calculation of diluted net income per share as their inclusion would have been anti-dilutive. The following table summarizes the potential common shares excluded from the diluted calculation (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| Employee stock options | 241 | 373 | 363 | 501 |

Stock-Based Compensation

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

Stock-based compensation cost is measured at the grant date of the share-based awards based on their fair values, and is recognized on a straight line basis as expense over the vesting periods of the awards, net of an estimated forfeiture rate.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Stock-Based Compensation — (Continued)

Cash flows resulting from excess tax benefits are classified as part of cash flows from operating and financing activities. Excess tax benefits represent tax benefits related to stock-based compensation in excess of the associated deferred tax asset for such equity compensation. Net cash proceeds from the exercise of stock options were approximately $1.8 million and $700,000 for the three months ended September 30, 2010 and 2009, respectively. Net cash proceeds from the exercise of stock options were approximately $3.0 million and $1.0 million for the nine months ended September 30, 2010 and 2009, respectively. There were approximately $400,000 and $0 of excess tax benefits realized from stock option exercises for the three months ended September 30, 2010 and 2009, respectively. There were approximately $700,000 and $0 of excess tax benefits realized from stock option exercises for the nine months ended September 30, 2010 and 2009, respectively.

Stock-based compensation expense for stock options, restricted stock and stock purchases under the employee stock purchase plan included in the Company's results of operations for the three and nine months ended September 30, 2010 and 2009, was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| Cost of revenues | $300 | $282 | $973 | $593 |
| Selling and marketing | 351 | 426 | 940 | 1,031 |
| Software development | 153 | 140 | 560 | 464 |
| General and administrative | 977 | 1,193 | 3,254 | 3,079 |
| Total stock-based compensation | $1,781 | $2,041 | $5,727 | $5,167 |

Options to purchase 68,560 and 22,407 shares were exercised during the three months ended September 30, 2010 and 2009, respectively. Options to purchase 107,217 and 28,618 shares were exercised during the nine months ended September 30, 2010 and 2009, respectively.

Recent Accounting Pronouncements

There have been no developments to the Recent Accounting Pronouncements discussion included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, including the expected dates of adoption and estimated effects on the Company's consolidated financial statements, except for the following:

In February 2010, the Financial Accounting Standards Board ("FASB") issued authoritative guidance that amends the disclosure requirements related to subsequent events. This guidance includes the definition of a Securities and Exchange Commission filer, removes the definition of a public entity, redefines the reissuance disclosure requirements and allows public companies to omit the disclosure of the date through which subsequent events have been evaluated. This guidance is effective for financial statements issued for interim and annual periods ending after February 2010. This guidance did not materially impact the Company's results of operations or financial position, but did require changes to the Company's disclosures in its financial statements.

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COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (CONTINUED)

Recent Accounting Pronouncements — (Continued)

In April 2010, the FASB issued authoritative guidance related to the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. A vendor can recognize consideration that is contingent upon achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved if the milestone is: (a) commensurate with either the vendor's performance to achieve the milestone or the enhancement of the value of the item delivered; (b) relates solely to past performance; and (c) is reasonable relative to all deliverables and payment terms in the arrangement. This guidance is effective on a prospective basis for financial statements issued for interim and annual periods ending after June 15, 2010 with early adoption permitted. The adoption of this guidance did not have a material impact on the Company's results of operations or financial position.

3. ACQUISITIONS

On July 17, 2009, the Company acquired all of the issued and outstanding equity securities of Property and Portfolio Research, Inc. ("PPR") and its wholly owned subsidiary Property and Portfolio Research Ltd., providers of real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry. The Company acquired PPR from DMG Information, Inc. ("DMGI") in exchange for 572,999 shares of CoStar common stock, which had an aggregate value of approximately $20.9 million as of the closing date. On July 17, 2009, 433,667 shares of the Company's common stock were issued to DMGI, and the remaining 139,332 shares were issued to DMGI on September 28, 2009 after taking into account post-closing purchase price adjustments.

The purchase price for the PPR acquisition was allocated as follows (in thousands):

| | |
|---|---|
| Working capital | $(5,479) |
| Acquired trade names and other | 810 |
| Acquired customer base | 5,300 |
| Acquired database technology | 3,700 |
| Goodwill | 16,572 |
| Total purchase consideration | $20,903 |

On October 19, 2009, the Company acquired all of the outstanding capital stock of Resolve Technology, Inc. ("Resolve Technology"), a Delaware corporation, for approximately $4.5 million, consisting of approximately $3.4 million in cash and 25,886 shares of CoStar common stock, which had an aggregate value of approximately $1.1 million as of the closing date, which shares are subject to a three-year lockup. Additionally, the seller may be entitled to receive (i) a potential deferred cash payment due approximately two years after closing based on the incremental growth of Resolve Technology's revenue as of September 2011 over its revenue as of September 2009, and (ii) other potential deferred cash payments for successful completion of operational and sales milestones during the period from closing through no later than October 31, 2013, which period may be extended by the parties to a date no later than December 31, 2014.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

3. ACQUISITIONS – (CONTINUED)

The purchase price for the Resolve Technology acquisition was allocated as follows (in thousands):

| | |
|---|---|
| Purchase price in cash and stock | $4,499 |
| Deferred consideration | 3,052 |
| Total purchase consideration | $7,551 |
| | |
| Working capital | $(550) |
| Acquired trade names and other | 430 |
| Acquired customer base | 890 |
| Acquired database technology | 1,200 |
| Goodwill | 5,581 |
| Total purchase consideration | $7,551 |

These acquisitions were accounted for using purchase accounting. For each of the PPR and Resolve Technology acquisitions, the purchase price was allocated to various working capital accounts, developed technology, customer base, trademarks, non-competition agreements and goodwill. The acquired customer base for the acquisitions, which consists of one distinct intangible asset for each acquisition and is composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over ten years. The identified intangibles are being amortized over their estimated useful lives. Goodwill for these acquisitions is not amortized, but is subject to annual impairment tests. Goodwill is comprised of acquired workforce. The results of operations of PPR and Resolve Technology have been consolidated with those of the Company since the respective dates of the acquisitions and are not considered material to the Company's consolidated financial statements. Accordingly, pro forma financial information has not been presented for any of the acquisitions.

4. INVESTMENTS

The Company determines the appropriate classification of debt and equity investments at the time of purchase and re-evaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. Short-term investments consist of commercial paper, government/federal notes and bonds and corporate obligations with maturities greater than 90 days at the time of purchase. Available-for-sale short-term investments with contractual maturities beyond one year are classified as current in the Company's consolidated balance sheets because they represent the investment of cash that is available for current operations. Long-term investments consist of variable rate debt instruments with an auction reset feature, referred to as auction rate securities ("ARS"). Investments are carried at fair market value.

Scheduled maturities of investments classified as available-for-sale as of September 30, 2010 are as follows (in thousands):

| Maturity Due: | Fair Value |
|---|---|
| October 1, 2010 ¾ September 30, 2011 | $3,356 |

| | |
|---|---|
| October 1, 2011 ¾ September 30, 2015 | 3,830 |
| October 1, 2015 ¾ September 30, 2020 | 79 |
| After September 30, 2020 | 29,349 |
| Available-for-sale investments | $36,614 |

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

4. INVESTMENTS — (CONTINUED)

The realized gains on the Company's investments for each of the three months ended September 30, 2010 and 2009 were approximately $8,000 and $0, respectively. The realized gains on the Company's investments for the nine months ended September 30, 2010 and 2009 were approximately $11,000 and $4,000, respectively. The realized losses on the Company's investments for each of the three months ended September 30, 2010 and 2009 were approximately $0 and $2,000, respectively. The realized losses on the Company's investments for the nine months ended September 30, 2010 and 2009 were approximately $41,000 and $4,000, respectively.

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

As of September 30, 2010, the amortized cost basis and fair value of investments classified as available-for-sale are as follows (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Collateralized debt obligations | $1,579 | $¾ | $¾ | $1,579 |
| Corporate debt securities | 5,371 | 236 | ¾ | 5,607 |
| Government-sponsored enterprise obligations | 80 | ¾ | (1) | 79 |
| Auction rate securities | 32,375 | ¾ | (3,026) | 29,349 |
| Available-for-sale investments | $39,405 | $236 | $(3,027) | $36,614 |

As of December 31, 2009, the amortized cost basis and fair value of investments classified as available-for-sale are as follows (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Collateralized debt obligations | $12,987 | $5 | $(14) | $12,978 |
| Corporate debt securities | 6,396 | 331 | ¾ | 6,727 |
| Residential mortgage-backed securities | 394 | ¾ | (7) | 387 |
| Government-sponsored enterprise obligations | 97 | ¾ | (1) | 96 |
| Auction rate securities | 32,750 | ¾ | (3,026) | 29,724 |
| Available-for-sale investments | $52,624 | $336 | $(3,048) | $49,912 |

The unrealized losses on the Company's investments as of September 30, 2010 and December 31, 2009 were generated primarily from changes in interest rates. The losses are considered temporary, as the contractual terms of these investments do not permit the issuer to settle the security at a price less than the amortized cost of the investment. Because the Company does not intend to sell these instruments and it is more likely than not that the Company will not be required to sell these instruments prior to anticipated recovery, which may be at maturity, it does not consider

these investments to be other-than-temporarily impaired as of September 30, 2010 and December 31, 2009, respectively. See Note 5 to the condensed consolidated financial statements for further discussion on the fair value of the Company's financial assets.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

4. INVESTMENTS — (CONTINUED)

The components of the Company's investments in an unrealized loss position for more than twelve months consist of the following (in thousands):

| | September 30, 2010 | | December 31, 2009 | |
|---|---|---|---|---|
| | Aggregate Fair Value | Gross Unrealized Losses | Aggregate Fair Value | Gross Unrealized Losses |
| | (unaudited) | | | |
| Collateralized debt obligations | $¾ | $¾ | $7,578 | $(14) |
| Residential mortgage-backed securities | ¾ | ¾ | 387 | (7) |
| Government-sponsored enterprise obligations | 79 | (1) | 96 | (1) |
| Auction rate securities | 29,349 | (3,026) | 29,724 | (3,026) |
| | $29,428 | $(3,027) | $37,785 | $(3,048) |

The Company did not have any investments in an unrealized loss position for less than twelve months as of September 30, 2010 and December 31, 2009, respectively.

5. FAIR VALUE

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

The following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) and liabilities measured at fair value on a recurring basis as of September 30, 2010 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets: | | | | |
| Cash | $56,110 | $¾ | $¾ | $56,110 |
| Money market funds | 139,248 | ¾ | ¾ | 139,248 |
| Collateralized debt obligations | ¾ | 1,579 | ¾ | 1,579 |
| Corporate debt securities | ¾ | 5,607 | ¾ | 5,607 |
| Government-sponsored enterprise obligations | ¾ | 79 | ¾ | 79 |
| Auction rate securities | ¾ | ¾ | 29,349 | 29,349 |
| Total assets measured at fair value | $195,358 | $7,265 | $29,349 | $231,972 |
| Liabilities: | | | | |
| Deferred consideration | $¾ | $¾ | $3,186 | $3,186 |
| Total liabilities measured at fair value | $¾ | $¾ | $3,186 | $3,186 |

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COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

5. FAIR VALUE — (CONTINUED)

The following table represents the Company's fair value hierarchy for its financial assets (cash, cash equivalents and investments) and liabilities measured at fair value on a recurring basis as of December 31, 2009 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets: | | | | |
| Cash | $38,721 | $¾ | $¾ | $38,721 |
| Money market funds | 167,065 | ¾ | ¾ | 167,065 |
| Collateralized debt obligations | ¾ | 12,978 | ¾ | 12,978 |
| Corporate debt securities | ¾ | 6,727 | ¾ | 6,727 |
| Residential mortgage-backed securities | ¾ | 387 | ¾ | 387 |
| Government-sponsored enterprise obligations | ¾ | 96 | ¾ | 96 |
| Auction rate securities | ¾ | ¾ | 29,724 | 29,724 |
| Total assets measured at fair value | $205,786 | $20,188 | $29,724 | $255,698 |
| Liabilities: | | | | |
| Deferred consideration | $¾ | $¾ | $3,082 | $3,082 |
| Total liabilities measured at fair value | $¾ | $¾ | $3,082 | $3,082 |

The Company’s Level 2 assets consist of collateralized debt obligations, corporate debt securities, residential mortgage-backed securities and government-sponsored enterprise obligations, which do not have directly observable quoted prices in active markets. The Company’s Level 2 assets are valued using matrix pricing.

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

The following tables summarize changes in fair value of the Company’s Level 3 assets for the three and nine months ended September 30, 2010 and 2009 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| Balance at beginning of period | $29,449 | $30,110 | $29,724 | $29,340 |
| Unrealized gain (loss) included in other comprehensive loss | ¾ | (71) | ¾ | 724 |
| Net settlements | (100) | (100) | (375) | (125) |
| Balance at end of period (unaudited) | $29,349 | $29,939 | $29,349 | $29,939 |

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

5. FAIR VALUE — (CONTINUED)

The following table summarizes changes in fair value of the Company's Level 3 assets from December 31, 2007 to September 30, 2010 (in thousands):

| | Auction Rate Securities |
|---|---|
| Balance at December 31, 2007 | $53,975 |
| Unrealized loss included in other comprehensive loss | (3,710) |
| Net settlements | (20,925) |
| Balance at December 31, 2008 | 29,340 |
| Unrealized gain included in other comprehensive loss | 684 |
| Net settlements | (300) |
| Balance at December 31, 2009 | 29,724 |
| Unrealized loss included in other comprehensive loss | ¾ |
| Net settlements | (175) |
| Balance at March 31, 2010 (unaudited) | 29,549 |
| Unrealized loss included in other comprehensive loss | ¾ |
| Net settlements | (100) |
| Balance at June 30, 2010 (unaudited) | 29,449 |
| Unrealized loss included in other comprehensive loss | ¾ |
| Net settlements | (100) |
| Balance at September 30, 2010 (unaudited) | $29,349 |

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

As of September 30, 2010, the Company held ARS with $32.4 million par value, all of which failed to settle at auction. The majority of these investments are of high credit quality with AAA credit ratings and are primarily student loan securities supported by guarantees from the FFELP of the U.S. Department of Education. The Company may not be able to liquidate and fully recover the carrying value of the ARS in the near term. As a result, these securities are classified as long-term investments in the Company's condensed consolidated balance sheet as of September 30, 2010.

While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. The Company has used a discounted cash flow model to determine the estimated fair value of its investment in ARS as of September 30, 2010. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of cash flows, liquidity risk premiums, expected holding periods and default risk. Based on this assessment of fair value, as of September 30, 2010, the Company determined there was a decline in the fair value of its ARS investments of approximately $3.0 million. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. In addition, while a majority of the ARS are currently rated AAA, if the issuers are unable to successfully close future auctions and/or their credit ratings deteriorate, the Company may be required to record additional unrealized losses in accumulated other comprehensive

loss or an other-than-temporary impairment charge to earnings on these investments.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

5. FAIR VALUE — (CONTINUED)

As of September 30, 2010, the Company's Level 3 liabilities consist of a $3.2 million liability for deferred consideration related to the October 19, 2009 acquisition of Resolve Technology. The deferred consideration includes (i) a potential deferred cash payment due approximately two years after closing based on the incremental growth of Resolve Technology's revenue as of September 2011 over its revenue as of September 2009, and (ii) other potential deferred cash payments for successful completion of operational and sales milestones during the period from closing through no later than October 31, 2013, which period may be extended by the parties to a date no later than December 31, 2014.

The following tables summarize changes in fair value of the Company's Level 3 liabilities for the three and nine months ended September 30, 2010 (in thousands):

| | Three Months Ended September 30, 2010 | Nine Months Ended September 30, 2010 |
|---|---|---|
| Balance at beginning of period | $3,158 | $3,082 |
| Accretion for period | 28 | 104 |
| Balance at end of period (unaudited) | $3,186 | $3,186 |

There were no Level 3 liabilities as of September 30, 2009.

The following table summarizes changes in fair value of the Company's Level 3 liabilities from December 31, 2008 to September 30, 2010 (in thousands):

| | Deferred Consideration |
|---|---|
| Balance at December 31, 2008 | $ ¾ |
| Deferred consideration upon acquisition | 3,052 |
| Accretion included in general and administrative expenses | 30 |
| Balance at December 31, 2009 | 3,082 |
| Accretion included in general and administrative expenses | 38 |
| Balance at March 31, 2010 (unaudited) | 3,120 |
| Accretion included in general and administrative expenses | 38 |
| Balance at June 30, 2010 (unaudited) | 3,158 |
| Accretion included in general and administrative expenses | 28 |
| Balance at September 30, 2010 (unaudited) | $ 3,186 |

The Company used a discounted cash flow model to determine the estimated fair value of its Level 3 liabilities as of September 30, 2010. The significant assumptions used in preparing the discounted cash flow model include the discount rate, estimates for future incremental revenue growth and probabilities for completion of operational and sales milestones.

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COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

5. FAIR VALUE — (CONTINUED)

Concentration of Credit Risk and Financial Instruments

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

6. GOODWILL

The changes in the carrying amount of goodwill by operating segment from December 31, 2008 to September 30, 2010 consist of the following (in thousands):

| | United States | International | Total |
|---|---|---|---|
| Goodwill, December 31, 2008 | $31,547 | $ 22,781 | $54,328 |
| Acquisitions | 23,858 | ¾ | 23,858 |
| Effect of foreign currency translation | ¾ | 2,280 | 2,280 |
| Purchase accounting adjustment | (145) | ¾ | (145) |
| Goodwill, December 31, 2009 | 55,260 | 25,061 | 80,321 |
| Effect of foreign currency translation | ¾ | (187) | (187) |
| Goodwill, September 30, 2010 (unaudited) | $55,260 | $ 24,874 | $80,134 |

The Company recorded goodwill of approximately $1.1 million in connection with the First CLS, Inc. acquisition in April 2008, which was decreased by $145,000 in 2009, upon completion of purchase accounting. Approximately $1.7 million in additional goodwill was recorded in connection with the First CLS, Inc. acquisition as a result of the payment of deferred consideration of $1.7 million in August 2009. The Company recorded goodwill of approximately $16.6 million in connection with the July 2009 acquisition of PPR. In July 2009, the Company had recorded $12.1 million in goodwill for the PPR acquisition, which was increased by $4.5 million in December 2009 upon completion of the Company's review of the income tax attributes and deferred taxes related to the PPR purchase accounting. The Company recorded goodwill of approximately $5.6 million in connection with the Resolve Technology acquisition in October 2009.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

7. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consist of the following (in thousands, except amortization period data):

| | September 30, 2010 (unaudited) | December 31, 2009 | Weighted-Average Amortization Period (in years) |
|---|---|---|---|
| Building photography | $11,705 | $11,504 | 5 |
| Accumulated amortization | (10,028) | (9,089) | |
| Building photography, net | 1,677 | 2,415 | |
| | | | |
| Acquired database technology | 26,075 | 25,790 | 4 |
| Accumulated amortization | (21,921) | (21,144) | |
| Acquired database technology, net | 4,154 | 4,646 | |
| | | | |
| Acquired customer base | 55,669 | 55,770 | 10 |
| Accumulated amortization | (42,982) | (41,208) | |
| Acquired customer base, net | 12,687 | 14,562 | |
| | | | |
| Acquired trade names and other | 9,725 | 9,755 | 7 |
| Accumulated amortization | (8,278) | (7,988) | |
| Acquired trade names and other, net | 1,447 | 1,767 | |
| | | | |
| Intangibles and other assets, net | $19,965 | $23,390 | |

8. INCOME TAXES

The income tax provision for the nine months ended September 30, 2010 and 2009 reflects an effective tax rate of approximately 42% and 44%, respectively.

9. COMMITMENTS AND CONTINGENCIES

The Company and its wholly owned subsidiary CoStar U.K. Limited were defendants in legal proceedings filed in England by Nokia U.K. Limited ("Nokia") related to a dispute concerning the Company's termination of an agreement to lease certain office space from Nokia. Nokia served its complaint upon the Company in September 2009. In June 2010, the Company accrued approximately $2.0 million in general and administrative expense in anticipation of paying this amount as part of a settlement of this lawsuit. On July 20, 2010, the parties signed a settlement agreement formally resolving this litigation and the Company subsequently paid approximately $2.0 million to Nokia.

On December 23, 2008, the Company initiated a Financial Industry Regulatory Authority ("FINRA") arbitration against Credit Suisse First Boston ("CSFB") related to CSFB's purchase of ARS for the Company's account. The Company's complaint included breach of contract, fraud, breach of fiduciary duty and other causes of action in relation to representations made by CSFB about the ARS purchased for CoStar's account. In September 2010, the FINRA

arbitration panel ruled in favor of CSFB. The Company did not have a gain or incur a loss as a result of the resolution of this matter.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

9. COMMITMENTS AND CONTINGENCIES — (CONTINUED)

On December 8, 2009, a former employee filed a lawsuit against the Company in the United States District Court for the Southern District of California alleging violations of the Fair Labor Standards Act and California state wage-and-hour laws and is seeking unspecified damages under those laws. The complaint also seeks to declare a class of all similarly situated employees to pursue similar claims. In May 2010, the parties reached a preliminary agreement to settle this lawsuit, and in June 2010, the Company accrued approximately $800,000 in general and administrative expense in anticipation of making a settlement payment that will formally resolve this litigation.

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. In accordance with GAAP, the Company records a provision for a liability when it is both probable that a liability has been incurred and the amount can be reasonably estimated. At September 30, 2010, while it is reasonably possible that an unfavorable outcome may occur as a result of one or more of the Company's current litigation matters, management has concluded that it is not probable that a loss has been incurred in connection with the Company's current litigation other than as described above. In addition, the Company is unable to estimate the possible loss or range of loss that could result from an unfavorable outcome in the Company's current litigation and accordingly, the Company has not recognized any liability in the condensed consolidated financial statements for unfavorable results, if any, other than described above. Legal defense costs are expensed as incurred.

10. SEGMENT REPORTING

The Company manages its business geographically in two operating segments, with the primary areas of measurement and decision-making being the U.S. and International, which includes the U.K. and France. The Company's subscription-based information services, consisting primarily of CoStar Property Professional®, CoStar Tenant®, CoStar COMPS Professional®, and FOCUSTM services, currently generate approximately 94% of the Company's total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise the Company's primary service offering in the U.S. operating segment. FOCUS is the Company's primary service offering in the International operating segment. Management relies on an internal management reporting process that provides revenue and operating segment EBITDA, which is the Company's net income before interest, income taxes, depreciation and amortization. Management believes that operating segment EBITDA is an appropriate measure for evaluating the operational performance of our operating segments. EBITDA is used by management to internally measure operating and management performance and to evaluate the performance of the business. However, this measure should be considered in addition to, not as a substitute for or superior to, income from operations or other measures of financial performance prepared in accordance with GAAP.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

10. SEGMENT REPORTING — (CONTINUED)

Summarized information by operating segment was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| Revenues | | | | |
| United States | $52,622 | $48,807 | $154,777 | $141,590 |
| International | | | | |
| External customers | 4,522 | 4,783 | 13,298 | 13,434 |
| Intersegment revenue | 299 | 308 | 990 | 308 |
| Total international revenue | 4,821 | 5,091 | 14,288 | 13,742 |
| Intersegment eliminations | (299) | (308) | (990) | (308) |
| Total revenues | $57,144 | $53,590 | $168,075 | $155,024 |
| | | | | |
| EBITDA | | | | |
| United States | $9,507 | $10,646 | $29,092 | $37,202 |
| International | (65) | (87) | (3,103) | (577) |
| Total EBITDA | $9,442 | $10,559 | $25,989 | $36,625 |
| | | | | |
| Reconciliation of EBITDA to net income | | | | |
| EBITDA | $9,442 | $10,559 | $25,989 | $36,625 |
| Purchase amortization in cost of revenues | (327) | (659) | (1,142) | (1,641) |
| Purchase amortization in operating expenses | (540) | (842) | (1,762) | (2,530) |
| Depreciation and other amortization | (2,440) | (2,107) | (7,357) | (6,571) |
| Interest income, net | 156 | 263 | 590 | 1,027 |
| Income tax expense, net | (2,909) | (2,889) | (6,796) | (11,863) |
| Net income | $3,382 | $4,325 | $9,522 | $15,047 |

Intersegment revenue is attributable to services performed by Property and Portfolio Research Ltd., a wholly owned subsidiary of PPR, for PPR. Intersegment revenue is recorded at an amount the Company believes approximates fair value. U.S. EBITDA includes a corresponding cost for the services performed by Property and Portfolio Research Ltd. for PPR. PPR was acquired in July 2009.

International EBITDA includes a corporate allocation of approximately $100,000 and $200,000 for the three months ended September 30, 2010 and 2009, respectively and $400,000 and $300,000 for the nine months ended September 30, 2010 and 2009, respectively. The corporate allocation represents costs incurred for U.S. employees involved in management and expansion activities of the Company’s International operating segment.

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

10. SEGMENT REPORTING — (CONTINUED)

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

| | September 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| Fixed assets, net | | |
| United States | $61,736 | $14,851 |
| International | 3,237 | 4,311 |
| Total fixed assets, net | $64,973 | $19,162 |
| | | |
| Goodwill | | |
| United States | $55,260 | $55,260 |
| International | 24,874 | 25,061 |
| Total goodwill | $80,134 | $80,321 |
| | | |
| Assets | | |
| United States | $455,372 | $424,479 |
| International | 41,053 | 44,558 |
| Total operating segment assets | $496,425 | $469,037 |
| | | |
| Reconciliation of operating segment assets to total assets | | |
| Total operating segment assets | $496,425 | $469,037 |
| Investment in subsidiaries | (18,344) | (18,344) |
| Intercompany receivables | (50,182) | (46,114) |
| Total assets | $427,899 | $404,579 |
| | | |
| Liabilities | | |
| United States | $45,190 | $37,838 |
| International | 49,228 | 46,678 |
| Total operating segment liabilities | $94,418 | $84,516 |
| | | |
| Reconciliation of operating segment liabilities to total liabilities | | |
| Total operating segment liabilities | $94,418 | $84,516 |
| Intercompany payables | (42,797) | (38,943) |
| Total liabilities | $51,621 | $45,573 |

COSTAR GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) — (CONTINUED)

11. PURCHASE OF BUILDING

In February 2010, the Company purchased a 169,429 square-foot LEED Gold certified office building located at 1331 L Street, NW in downtown Washington, D.C. together with the tenancy in the underlying ground lease for the property for a purchase price of $41.25 million in cash. This facility will be used primarily by the Company's U.S. segment. The Company began relocating its Bethesda-based employees and infrastructure to the new building starting in July 2010 and completed its relocation by October 15, 2010, the expiration date of the lease of its Bethesda property.

In connection with the purchase of the building, the Company assumed the ground lease for the parcel of land under the building. The lease, which expires February 29, 2088, requires the payment of minimum annual rent of $778,000 through February 29, 2012, then approximately $918,000 annually through February 29, 2024. Thereafter, the minimum rate is adjusted to fair market value, as defined in the lease, once every 7 years.

The purchase of the building was accounted for as an asset acquisition. The total purchase price of $41.25 million, plus $1.7 million of direct transaction costs was allocated to the building. No other significant assets or liabilities were acquired in this transaction.

12. RELATED PARTY TRANSACTIONS

The Company has entered into two separate agreements with ghSMART & Company, Inc. ("ghSMART"), a management consulting firm. Each agreement relates to the engagement of ghSMART to provide services in connection with a different phase of evaluation of the Company's sales force senior management and to provide guidance with respect to hiring and recruiting best practices for the Company's sales force. Randy Street, a Partner of ghSMART, is the brother-in-law of the Company's Chief Executive Officer. Mr. Street has acted and will continue to act as the senior client manager for each phase of the project. He has a less than 0.5 percent equity stake in ghSMART. Mr. Street is paid 25 percent of the amounts paid by the Company pursuant to the engagements. The Company entered into the phase I and phase II engagements in April 2009 and October 2009, respectively, and has paid ghSMART approximately $202,000 plus expenses for phase I and approximately $255,000 plus expenses for phase II. The Audit Committee has reviewed and approved each of the engagements with ghSMART prior to commencement of the respective engagement. The Company may enter into additional engagements with ghSMART in the future, subject to the review and approval of the Audit Committee.

13. LEASE RESTRUCTURING CHARGES

Effective September 24, 2010, the Company consolidated its three facilities located in the Boston, Massachusetts area, including the facilities used by CoStar, PPR, and Resolve Technology, into one facility. The consolidation of the facilities resulted in a lease restructuring charge of approximately $1.3 million recorded in general and administrative expense in the third quarter of 2010. The third quarter lease restructuring charge included amounts for the abandonment of certain lease space and the impairment of leasehold improvements. The amount of the lease restructuring charge was based upon management's best estimate of amounts and timing of certain events that will occur in the future. It is possible that the actual outcome of these events may differ from estimates. Changes will be made to the restructuring accrual when any such differences become determinable. As of September 30, 2010, there is approximately $1.2 million included in accrued expenses related to these restructuring charges.

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

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

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

Overview

CoStar Group, Inc. ("CoStar") is the number one provider of information, marketing and analytic services to the commercial real estate industry in the U.S. and the U.K. based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department in the industry, provide more information, marketing and analytic services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information, marketing and analytic platform where members of the commercial real estate and related business community can continuously interact and facilitate transactions by efficiently exchanging accurate and standardized commercial real estate information. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, internet marketing services, analytical capabilities, information for clients' websites, information about industry professionals and their business relationships, data integration and industry news. We also provide market research and analysis for commercial real estate investors and lenders via our Property and Portfolio Research, Inc. ("PPR") service offerings and portfolio and debt management and reporting capabilities through our Resolve Technology, Inc. ("Resolve Technology") service offerings. Our service offerings span all commercial property types, including office, industrial, retail, land, mixed-use, hospitality and multifamily.

Since 1994, we have expanded the geographical coverage of our existing information and marketing services and developed new information, marketing and analytic services. This expansion included the acquisitions of Chicago ReSource, Inc. in Chicago in 1996 and New Market Systems, Inc. in San Francisco in 1997. In August 1998, we expanded into the Houston region through the acquisition of Houston-based real estate information provider C Data Services, Inc. In January 1999, we expanded further into the Midwest and Florida by acquiring LeaseTrend, Inc. and into Atlanta and Dallas/Fort Worth by acquiring Jamison Research, Inc. In February 2000, we acquired COMPS.COM, Inc., a San Diego-based provider of commercial real estate information. In November 2000, we acquired First Image Technologies, Inc., a California-based provider of commercial real estate software. In September 2002, we expanded further into Portland, Oregon through the acquisition of certain assets of Napier Realty Advisors (doing business as REAL-NET). In January 2003, we established a base in the U.K. with our acquisition of London-based FOCUS Information Limited. In May 2004, we expanded into Tennessee through the acquisition of Peer Market Research, Inc., and in September 2004, we extended our coverage of the U.K. through the acquisition of Scottish Property Network. In September 2004, we strengthened our position in Colorado through the acquisition of substantially all of the assets of Denver-based RealComp, Inc., a local comparable sales information provider.

In January 2005, we acquired National Research Bureau, a Connecticut-based provider of U.S. shopping center information. In December 2006, our U.K. subsidiary, CoStar Limited, acquired Grecam S.A.S. ("Grecam"), a provider

of commercial property information and market-level surveys, studies and consulting services located in Paris, France. In February 2007, CoStar Limited also acquired Property Investment Exchange Limited ("Propex"), a provider of commercial property information and operator of an electronic platform that facilitates the exchange of investment property located in London, England. In April 2008, we acquired the assets of First CLS, Inc. (doing business as the Dorey Companies and DoreyPRO), an Atlanta-based provider of local commercial real estate information. Most recently, in July 2009, we acquired Massachusetts-based PPR, a provider of real estate analysis, market forecasts and

credit risk analytics to the commercial real estate industry, and its wholly owned U.K. subsidiary Property and Portfolio Research Ltd., and in October 2009, we acquired Massachusetts-based Resolve Technology, a provider of business intelligence and portfolio management software serving the institutional real estate investment industry. The PPR and Resolve Technology acquisitions are discussed later in this section under the heading "Recent Acquisitions."

We have consistently worked to expand our service offerings, both in terms of geographical coverage and the scope of services offered, in order to position the company for future revenue growth. In 2004, we began our expansion into 21 new metropolitan markets throughout the U.S. and began expanding the geographical coverage of many of our existing U.S. and U.K. markets. We completed our expansion into the 21 new markets in the first quarter of 2006. During the second half of 2006, in order to further expand the geographical coverage of our service offerings, we began actively researching commercial properties in 81 new Core Based Statistical Areas ("CBSAs") in the U.S., we increased our U.S. field research fleet by adding 89 vehicles and we hired researchers to staff these vehicles. We released our CoStar Property Professional service in the 81 new CBSAs across the U.S. in the fourth quarter of 2007.

In early 2005, in conjunction with the acquisition of National Research Bureau, we launched a major effort to expand our coverage of retail real estate information. The retail component of our flagship product, CoStar Property Professional, was unveiled in May 2006 at the International Council of Shopping Centers' convention in Las Vegas. In May 2008, we released CoStar Showcase®, an Internet marketing service that provides commercial real estate professionals the ability to make their listings accessible to all visitors to www.CoStar.com and www.Showcase.com. During the second half of 2009, as a part of our strategy to provide subscribers with tools for conducting primary research and analysis on commercial real estate, we expanded subscribers' capabilities to use CoStar's database of research-verified commercial property information to conduct in-depth analysis and generate reports on trends in sales and leasing activity online.

Our goal is to provide additional tools that make our research and analytics even more valuable to subscribers. We are currently focusing on integration and further development of the PPR and Resolve Technology service offerings. We have launched an initiative to develop a discounted cash flow (DCF) forecasting and valuation solution that effectively integrates the combined capabilities of CoStar's market and property information and PPR's analytics and forecasting expertise with Resolve Technology's real estate investment software expertise. In order to implement this initiative, we have incurred, and expect to continue to incur additional costs, including costs of hiring additional personnel. While our investments in PPR and Resolve Technology have resulted and may continue to result in an increase in expenses, our revenues have also increased as a result of these acquisitions, and we have experienced increased cross-selling opportunities among CoStar and the acquired companies.

We have also focused on expanding our geographical coverage and service offerings through our international operations. We intend to integrate our international operations, including our acquisitions of Propex, Grecam and PPR's wholly owned subsidiary Property and Portfolio Research Ltd., more fully with those in the U.S. We intend to eventually introduce a consistent international platform of service offerings. In 2007, we introduced the "CoStar Group" as the brand encompassing our international operations, and in early 2010 we launched Showcase, our Internet marketing service, in the U.K. We believe that our recent U.S. and international expansion and integration efforts will be a platform for long-term growth.

We intend to continue to expand the breadth and depth of our platform and market coverage through acquisitions. Specifically, we plan to continue to target acquisition candidates that we believe will enable us to leverage our existing assets, including our database, service offerings and sales force, in ways that enhance the value of our services to subscribers, create additional growth opportunities and generate future revenues.

In addition, we expect to continue to develop and distribute new services, expand existing services within our current platform, and expand and develop our sales and marketing organization. Any future expansion, including expansion

through acquisitions and expansion internationally, could reduce our profitability and increase our capital expenditures. Therefore, while we expect current service offerings to remain profitable, driving overall earnings throughout 2010 and providing substantial cash flow for our business, it is possible that any new investments could cause us to generate losses and negative cash flow from operations in the future.

We recently decided to take advantage of favorable market conditions to lower our long-term occupancy costs as a tenant. In February 2010, we purchased an office building in downtown Washington, D.C. for $41.25 million for use as our new headquarters and have since relocated to this location. The lease for our previous headquarters in Bethesda, MD expired on October 15, 2010; therefore, we incurred overlapping occupancy costs through the end of the Bethesda lease term as we transitioned to our new headquarters. Now that the relocation is complete, we expect to realize long-term savings in occupancy costs. As part of our overall strategy to consolidate our London office locations and reduce occupancy costs, we also relocated our London offices and in July 2010 entered into a settlement pursuant to which we terminated our lease for our former London offices. In addition, in September 2010, we consolidated our three facilities located in the Boston, Massachusetts area, including the facilities used by CoStar, PPR and Resolve Technology, into one facility. We recorded a lease restructuring charge of approximately $1.3 million in general and administrative expense in the third quarter of 2010 as a result of the Boston office consolidation. We expect capital expenditures to increase in 2010 primarily for facilities related capital expenditures.

In some cases, the business operations of some of our clients continue to be negatively affected by challenging economic conditions in the U.S. and the world, resulting at times in business consolidations and, in extreme circumstances, business failure. However, clear signs of improving conditions in commercial real estate, including heightened leasing activity and positive net absorption of office space, are resulting from the modest office-related job growth and business expansions occurring in the face of renewed economic expansion. In this improving environment, CoStar Group's trailing twelve-month renewal rate for subscription-based services increased back towards our average of 90% during the third quarter of 2010. For the twelve months ended September 30, 2010 and 2009, our contract renewal rate for subscription-based services was approximately 90% and 85%, respectively, and therefore our cancellation rate was approximately 10% and 15%, respectively, for the same periods of time. Our contract renewal rate is a quantitative measurement that is typically closely correlated with our revenue results. As a result, management also believes that the rate may be a reliable indicator of short-term and long-term performance. Our trailing twelve-month contract renewal rate may decline if negative economic conditions lead to greater business failures and/or consolidations among our clients, further reductions in customer spending, or decreases in our customer base.

Fluctuations in commercial real estate leasing activity and vacancy rates, as well as office-related employment and other economic and financial factors that affect the commercial real estate industry, may have a corresponding positive or negative effect on the number of our subscribers and average contract value, both of which directly affect our financial condition and results of operations. While we believe we are seeing the initial stages of recovery in the commercial real estate economy, the extent and duration of any future strengthening or weakening of the overall economy and how it may affect the commercial real estate economy is unknown. Likewise, the extent and duration of any benefit resulting from any of the governmental or private sector initiatives designed to strengthen the economy are unknown and there can be no assurance that such initiatives have been or will be successful. Because of these uncertainties and any resulting impact on our business, we may not be able to accurately forecast our revenue or earnings. However, based on current economic conditions, we believe that the Company is positioned to generate continued, sustained earnings from current operations in the fourth quarter of 2010 and for the foreseeable future.

We believe that our increasing diversification beyond the U.S. economy through our international businesses benefits our stockholders over the long term. Our financial reporting currency is the U.S. dollar. Changes in exchange rates can significantly affect our reported results and consolidated trends. Currency exchange rate volatility may continue, which may impact (either positively or negatively) our reported financial results and trends and period-to-period comparisons of our consolidated operations.

We currently issue stock options and restricted stock to our officers, directors and employees, and as a result we record additional compensation expense in our condensed consolidated statements of operations. We plan to continue the use of stock-based compensation for our officers, directors and employees, which may include, among other

things, restricted stock or stock option grants that typically will require us to record additional compensation expense in our condensed consolidated statements of operations and reduce our net income.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, and FOCUS services currently generate approximately 94% of our total revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. FOCUS is our primary service offering in our International operating segment. The majority of our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may change in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based information services rather than fees based on actual system usage. Contract rates are generally based on the number of sites, number of users, organization size, the client's business focus, geography and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. We recognize this revenue on a straight-line basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

Application of Critical Accounting Policies and Estimates

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

Fair Value of Auction Rate Securities

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

Our ARS investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. We have used a discounted cash flow model to determine the estimated fair value of our investment in ARS as of September 30, 2010. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, credit spreads, timing and amount of cash flows, liquidity risk premiums, expected holding periods and default risk of the ARS. Based on this assessment of fair value, as of September 30, 2010, we determined there was a decline in the fair value of our ARS investments of approximately $3.0 million. The decline was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. If the issuers of these ARS are unable to successfully close future auctions and/or their credit ratings deteriorate, we may be required to record additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments, which would reduce our profitability and adversely affect our financial position.

We have not made any material changes in the accounting methodology used to determine the fair value of the ARS. We do not expect any material changes in the near term to the underlying assumptions used to determine the unobservable inputs used to calculate the fair value of the ARS as of September 30, 2010. However, if changes in these assumptions do occur, and, should those changes be significant, we may be exposed to additional unrealized losses in accumulated other comprehensive loss or an other-than-temporary impairment charge to earnings on these investments.

Fair Value of Deferred Consideration

Our Level 3 liabilities consist of a $3.2 million liability as of September 30, 2010 for deferred consideration related to the October 19, 2009 acquisition of Resolve Technology. The deferred consideration is for (i) a potential deferred cash payout two years after closing based on the incremental growth of Resolve Technology's revenue, and (ii) other potential deferred cash payouts for successful completion of operational and sales milestones during the period from closing through October 31, 2013, which period may be extended by the parties to a date no later than December 31, 2014.

We have used a discounted cash flow model to determine the estimated fair value of our Level 3 liabilities as of September 30, 2010. The significant assumptions used in preparing the discounted cash flow model include the discount rate, estimates for future incremental revenue growth and probabilities for completion of operational and sales milestones.

We have not made any material changes in the accounting methodology used to determine the fair value of the deferred consideration. We do not expect any material changes in the near term to the underlying assumptions used to determine the unobservable inputs used to calculate the fair value of the deferred consideration as of September 30, 2010. However, if changes in these assumptions do occur, and, should those changes be significant, we may be exposed to additional liabilities related to this deferred consideration.

Stock-Based Compensation

Equity instruments issued in exchange for employee services are accounted for using a fair-value based method and the fair value of such equity instruments is recognized as an expense in the consolidated statements of operations. We estimated the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, which requires us to estimate the dividend yield, expected volatility, risk-free interest rate and expected life of the stock option. These assumptions and the estimation of expected forfeitures are based on multiple factors, including historical employee behavior patterns of exercising options and post-employment termination behavior, expected future employee option exercise patterns, and the historical volatility of the Company's stock price.

We do not expect any material changes in the near term to the underlying assumptions used to calculate stock-based compensation expense for the nine months ended September 30, 2010. However, if changes in these assumptions do occur, and, should those changes be significant, they could have a material impact on our stock-based compensation expense.

Valuation of Long-Lived and Intangible Assets and Goodwill

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

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

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

Goodwill and identifiable intangible assets that are not subject to amortization are tested annually for impairment by each reporting unit on October 1 of each year and are also tested for impairment more frequently based upon the existence of one or more of the above indicators. We consider our operating segments, U.S. and International, as our reporting units under Financial Accounting Standards Board ("FASB") authoritative guidance for consideration of potential impairment of goodwill.

The goodwill impairment test is a two-step process. The first step is to determine the fair value of each reporting unit. We estimate the fair value of each reporting unit based on a projected discounted cash flow model that includes significant assumptions and estimates including our future financial performance and a weighted average cost of capital. The fair value of each reporting unit is compared to the carrying amount of the reporting unit. If the

carrying value of the reporting unit exceeds the fair value, then the second step of the process is performed to measure the impairment loss. We measure impairment loss based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk in our current business model. As of October 1, 2009, the most recent date of our impairment analysis, the estimated fair value of each of our reporting units substantially exceeded the carrying value of our reporting units. There have been no events or changes in circumstances since the date of our impairment analysis on October 1, 2009 that would indicate that the carrying value of each reporting unit may not be recoverable.

Accounting for Income Taxes

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

Non-GAAP Financial Measures

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

We view EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share as operating performance measures and as such we believe that the most directly comparable GAAP financial measure is net income (loss). In calculating EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share, we exclude from net income (loss) the financial items that we believe should be separately identified to provide additional analysis of the financial components of the day-to-day operation of our business. We have outlined below the type and scope of these exclusions and the material limitations on the use of these non-GAAP financial measures as a result of these exclusions. EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share are not measurements of financial performance under GAAP and should not be considered as

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

EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share may be used by management to internally measure our operating and management performance and may be used by investors as supplemental financial measures to evaluate the performance of our business. We believe that these non-GAAP measures, when viewed with our GAAP results and the accompanying reconciliation, provide additional information that is useful to understand the factors and trends affecting our business. We have spent more than 22 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complementary businesses. Due to the expansion of our information, marketing and analytic services, which included acquisitions, our net income (loss) has included significant charges for purchase amortization, depreciation and other amortization, acquisition costs and restructuring costs. EBITDA, adjusted EBITDA, non-GAAP net income and non-GAAP net income per diluted share exclude these charges and provide meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization, acquisition costs, restructuring costs and settlement and impairment costs incurred outside our ordinary course of business. We believe the disclosure of these non-GAAP measures can help investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe these non-GAAP measures are measures of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and other items, such as interest, income taxes, stock-based compensation expenses, acquisition costs, headquarters acquisition and transition related costs, restructuring costs and settlement and impairment costs incurred outside our ordinary course of business, provides additional information about our cost structure, and, over time, helps track our operating progress. In addition, investors, securities analysts and others have regularly relied on EBITDA and may rely on adjusted EBITDA, non-GAAP net income or non-GAAP net income per diluted share to provide a financial measure by which to compare our operating performance against that of other companies in our industry.

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

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

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

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

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

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

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

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

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

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

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

- The amount of headquarters acquisition and transition related costs incurred may be useful for investors to consider because they generally represent the overlapping rent and building carrying costs, legal costs and other related costs incurred to relocate our headquarters. We do not believe these charges necessarily reflect the current and ongoing charges related to our operating cost structure.

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

The financial items that have been excluded from our net income (loss) to calculate non-GAAP net income and non-GAAP net income per diluted share are stock-based compensation, acquisition related costs, restructuring costs, headquarter acquisition and transition related costs and settlement and impairment costs incurred outside our ordinary course of business which are discussed above with respect to the calculation of adjusted EBITDA along with the material limitations associated with using this non-GAAP financial measure as compared to net income (loss). We subtract an assumed provision for income taxes to calculate non-GAAP net income. We assume a 40% tax rate in order to approximate our long-term effective corporate tax rate.

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

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Net income | $3,382 | $4,325 | $9,522 | $15,047 |
| Purchase amortization in cost of revenues | 327 | 659 | 1,142 | 1,641 |
| Purchase amortization in operating expenses | 540 | 842 | 1,762 | 2,530 |
| Depreciation and other amortization | 2,440 | 2,107 | 7,357 | 6,571 |
| Interest income, net | (156) | (263) | (590) | (1,027) |
| Income tax expense, net | 2,909 | 2,889 | 6,796 | 11,863 |
| EBITDA | $9,442 | $10,559 | $25,989 | $36,625 |
| | | | | |
| Cash flows provided by (used in) | | | | |
| Operating activities | $6,396 | $12,937 | $27,095 | $31,814 |
| Investing activities | (1,465) | 4,171 | (39,890) | 7,824 |
| Financing activities | 2,018 | 575 | 2,540 | 506 |

Comparison of Three Months Ended September 30, 2010 and Three Months Ended September 30, 2009

Revenues. Revenues increased to $57.1 million in the third quarter of 2010 from $53.6 million in the third quarter of 2009. The $3.6 million increase was primarily attributable to further penetration of our subscription-based information services, and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates as well as additional revenues from our October 2009 acquisition of Resolve Technology of approximately $1.0 million. Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS, currently generate approximately 94% of our total revenues.

Gross Margin. Gross margin increased to $36.4 million in the third quarter of 2010 from $34.4 million in the third quarter of 2009. The increase in the gross margin amount was due to an increase in revenue partially offset by an increase in cost of revenues. The gross margin percentage decreased to 63.7% in the third quarter of 2010 from 64.3% in the third quarter of 2009. The decrease in the percentage of gross margin was principally due to an increase in the cost of revenues. Cost of revenues increased to $20.8 million for the third quarter of 2010 from $19.1 million for the third quarter of 2009. The increase in the cost of revenues was principally due to an increase in research personnel costs.

Selling and Marketing Expenses. Selling and marketing expenses increased to $13.0 million in the third quarter of 2010 from $11.6 million in the third quarter of 2009, and increased as a percentage of revenues to 22.8% in the third quarter of 2010 from 21.7% in the third quarter of 2009. The increase in the amount and percentage of selling and marketing expenses was primarily due to increased sales personnel costs.

Software Development Expenses. Software development expenses increased to $4.2 million in the third quarter of 2010 from $3.5 million in the third quarter of 2009, and increased as a percentage of revenues to 7.4% in the third quarter of 2010 compared to 6.4% in the third quarter of 2009. The increase in the amount and percentage of software development expenses was primarily due to additional software development expenses included as a result of our October 2009 acquisition of Resolve Technology.

General and Administrative Expenses. General and administrative expenses increased to $12.4 million in the third quarter of 2010 from $11.6 million in the third quarter of 2009, and increased as a percentage of revenues to 21.8% in the third quarter of 2010 compared to 21.6% in the third quarter of 2009. The increase in the amount and percentage of general and administrative expenses was primarily due to approximately $1.3 million for the lease restructuring charge partially offset by decreased bad debt expense of approximately $600,000.

Purchase Amortization. Purchase amortization decreased to approximately $500,000 in the third quarter of 2010 compared to approximately $800,000 in the third quarter of 2009, and decreased as a percentage of revenues to 0.9% in the third quarter of 2010 compared to 1.6% in the third quarter of 2009. The decrease in purchase amortization expense was due to the completion of amortization of certain identifiable intangible assets in 2010.

Interest and Other Income, net. Interest and other income, net remained relatively consistent at approximately $200,000 in the third quarter of 2010 and approximately $300,000 in the third quarter of 2009.

Income Tax Expense, net. Income tax expense, net remained relatively consistent at approximately $2.9 million in the third quarter of 2010 and 2009.

Comparison of Business Segment Results for Three Months Ended September 30, 2010 and Three Months Ended September 30, 2009

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

Segment Revenues. CoStar Property Professional, CoStar Tenant, and CoStar COMPS Professional are generally sold as a suite of similar services and comprise our primary service offering in our U.S. operating segment. U.S. revenues increased to $52.6 million in the third quarter of 2010 from $48.8 million in the third quarter of 2009. This increase in U.S. revenue was primarily due to further penetration of our subscription-based information services, and successful cross-selling of our services to our customers in existing markets, combined with continued high renewal rates, as well as additional revenues from our October 2009 acquisition of Resolve Technology of approximately $1.0 million. FOCUS is our primary service offering in our International operating segment. International revenues decreased to $4.8 million from $5.1 million for the three months ended September 30, 2010 and 2009, respectively. This decrease in international revenue is principally due to foreign currency fluctuations.

Segment EBITDA. U.S. EBITDA decreased to $9.5 million in the third quarter of 2010 from $10.6 million in the third quarter of 2009. The decrease in U.S. EBITDA was due primarily to a lease restructuring charge of approximately $1.3 million related to the consolidation of our three facilities located in Boston, Massachusetts. International EBITDA remained relatively consistent at a loss of approximately $100,000 in the third quarter of 2010 and 2009. International EBITDA includes a corporate allocation of approximately $100,000 and $200,000 for each of the three months ended September 30, 2010 and 2009, respectively. The corporate allocation represents costs incurred for U.S. employees involved in international management and expansion activities.

Comparison of Nine Months Ended September 30, 2010 and Nine Months Ended September 30, 2009

Revenues. Revenues increased to $168.1 million for the nine months ended September 30, 2010, from $155.0 million for the nine months ended September 30, 2009. The $13.1 million increase was primarily due to additional revenues as a result of our July 2009 acquisition of PPR. Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS, currently generate approximately 94% of our total revenues.

Gross Margin. Gross margin increased to $105.8 million for the nine months ended September 30, 2010, from $102.2 million for the nine months ended September 30, 2009. The increase in the gross margin amount was due to an increase in revenue partially offset by an increase in cost of revenues. Gross margin percentage decreased to 62.9% for the nine months ended September 30, 2010, from 65.9% for the nine months ended September 30, 2009. The decrease in the percentage of gross margin was principally due to an increase in the cost of revenues. Cost of revenues increased to $62.3 million for the nine months ended September 30, 2010 from $52.8 million for the nine months ended September 30, 2009. The increase in the cost of revenues was principally due to additional cost of revenues of approximately $6.5 million, included as a result of our July 2009 acquisition of PPR, as well as an increase in research personnel costs of approximately $2.8 million.

Selling and Marketing Expenses. Selling and marketing expenses increased to $38.5 million for the nine months ended September 30, 2010, from $30.5 million for the nine months ended September 30, 2009, and increased as a percentage of revenues to 22.9% for the nine months ended September 30, 2010, from 19.7% for the nine months ended September 30, 2009. The increase was primarily due to increased costs of approximately $4.4 million due to increased sales personnel costs, as well as additional selling and marketing expenses of approximately $1.6 million included as a result of our July 2009 acquisition of PPR.

Software Development Expenses. Software development expenses increased to $12.6 million for the nine months ended September 30, 2010, compared to $9.7 million for the nine months ended September 30, 2009, and increased as a percentage of revenues to 7.5% for the nine months ended September 30, 2010 compared to 6.3% for the nine months ended September 30, 2009. The increase in the amount and percentage of software development expense was primarily due to additional software development expenses included as a result of our July 2009 acquisition of PPR and our October 2009 acquisition of Resolve Technology.

General and Administrative Expenses. General and administrative expenses increased to $37.2 million for the nine months ended September 30, 2010, from $33.6 million for the nine months ended September 30, 2009, and increased as a percentage of revenues to 22.1% for the nine months ended September 30, 2010, compared to 21.7% for the nine months ended September 30, 2009. The increase in the amount of general and administrative expenses was primarily due to $2.8 million recorded for the settlement of two litigation matters in June 2010, the lease restructuring charge of approximately $1.3 million, and additional general and administrative expense of approximately $2.1 million included as a result of our July 2009 acquisition of PPR and our October 2009 acquisition of Resolve Technology, partially offset by a decrease in bad debt expense of approximately $2.4 million.

Purchase Amortization. Purchase amortization decreased to $1.8 million for the nine months ended September 30, 2010, compared to $2.5 million for the nine months ended September 30, 2009, and decreased as a percentage of revenues to 1.0% for the nine months ended September 30, 2010, from 1.6% for the nine months ended September 30, 2009. The decrease in purchase amortization expense was due to the completion of amortization for certain identifiable intangible assets in 2010.

Interest and Other Income, net. Interest and other income, net decreased to approximately $600,000 for the nine months ended September 30, 2010, from $1.0 million for the nine months ended September 30, 2009, primarily due to lower short-term investment balances.

Income Tax Expense, net. Income tax expense, net decreased to $6.8 million for the nine months ended September 30, 2010, from $11.9 million for the nine months ended September 30, 2009. This decrease was primarily due to lower income before income taxes.

Comparison of Business Segment Results for Nine Months Ended September 30, 2010 and Nine Months Ended September 30, 2009

Segment Revenues. U.S. revenues increased to $154.8 million from $141.6 million for the nine months ended September 30, 2010 and 2009, respectively. This increase in U.S. revenue was primarily due to additional revenues as a result of our July 2009 acquisition of PPR. International revenues increased to $14.3 million from $13.7 million for the nine months ended September 30, 2010 and 2009, respectively. This increase in international revenue was principally due to further penetration of our subscription-based information services.

Segment EBITDA. U.S. EBITDA decreased to $29.1 million from $37.2 million for the nine months ended September 30, 2010 and 2009, respectively. The decrease in U.S. EBITDA was due to additional personnel cost of approximately $7.8 million, increased legal settlement charges of approximately $800,000, and a lease restructuring charge of

approximately $1.3 million related to the consolidation of our three facilities located in Boston, Massachusetts partially offset by a decrease in bad debt expense of approximately $2.1 million. International EBITDA increased to a loss of $3.1 million from a loss of approximately $600,000 for the nine months ended September 30, 2010 and 2009, respectively. This increased loss was primarily due to approximately $2.0 million paid in connection with the settlement of our litigation with Nokia U.K. Limited. International EBITDA includes a corporate allocation of approximately $400,000 and $300,000 for the nine months ended September 30, 2010 and 2009, respectively. The corporate allocation represents costs incurred for U.S. employees involved in international management and expansion activities.

Recent Acquisitions

On July 17, 2009, we acquired all of the issued and outstanding equity securities of PPR, and its wholly owned subsidiary, Property and Portfolio Research Ltd., providers of real estate analysis, market forecasts and credit risk analytics to the commercial real estate industry. We acquired PPR from DMG Information, Inc. ("DMGI") in exchange for 572,999 shares of CoStar common stock, which had an aggregate value of approximately $20.9 million as of the closing date. On July 17, 2009, we issued 433,667 shares of our common stock to DMGI, and we issued the remaining 139,332 shares to DMGI on September 28, 2009 after taking into account post-closing purchase price adjustments.

On October 19, 2009, we acquired all of the outstanding capital stock of Resolve Technology, a Delaware corporation, for approximately $4.5 million, consisting of approximately $3.4 million in cash and 25,886 shares of CoStar common stock, which had an aggregate value of approximately $1.1 million as of the closing date, which shares are subject to a three-year lockup. The purchase price is subject to certain post-closing adjustments. Additionally, the seller may be entitled to receive (i) a potential deferred cash payment due approximately two years after closing based on the incremental growth of Resolve Technology's revenue as of September 2011 over its revenue as of September 2009, and (ii) other potential deferred cash payments for successful completion of operational and sales milestones during the period from closing through no later than October 31, 2013, which period may be extended by the parties to a date no later than December 31, 2014.

These acquisitions were accounted for using purchase accounting. For each of the PPR and Resolve Technology acquisitions, the purchase price was allocated to various working capital accounts, developed technology, customer base, trademarks, non-competition agreements and goodwill. The acquired customer base for the acquisitions, which consists of one distinct intangible asset for each acquisition and is composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over ten years. The identified intangibles will be amortized over their estimated useful lives. Goodwill for these acquisitions will not be amortized, but is subject to annual impairment tests. The results of operations of PPR and Resolve Technology have been consolidated with those of the Company since the respective dates of the acquisitions and are not considered material to our consolidated financial statements. Accordingly, pro forma financial information has not been presented for any of the acquisitions.

Liquidity and Capital Resources

Our principal sources of liquidity are cash, cash equivalents and short-term investments. Total cash, cash equivalents and short-term investments decreased to $202.6 million at September 30, 2010 from $226.0 million at December 31, 2009. The decrease in cash, cash equivalents and short-term investments for the nine months ended September 30, 2010 was primarily due to the purchase of a 169,429 square-foot LEED Gold certified office building located at 1331 L Street, NW in downtown Washington, D.C. for a purchase price of $41.25 million in cash, and approximately $1.7 million in acquisition costs, partially offset by cash flows from operations.

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

Net cash provided by operating activities for the nine months ended September 30, 2010 was $27.1 million compared to $31.8 million for the nine months ended September 30, 2009. This $4.7 million decrease was due to a decrease of $9.3 million in net income plus non-cash items partially offset by a $4.6 million net increase in changes in operating assets and liabilities due to differences in timing of collection of receipts and payments of disbursements. The $4.6 million net increase in changes in operating assets and liabilities was primarily related to approximately $2.5 million

in increased deferred revenue mostly associated with cash received for annual billings, as well as $800,000 accrued in June 2010 in anticipation of the settlement of a litigation matter and the $1.3 million lease restructuring charge associated with our Boston lease consolidation in September 2010.

Net cash used in investing activities was $39.9 million for the nine months ended September 30, 2010, compared to $7.8 million net cash provided by investing activities for the nine months ended September 30, 2009. This $47.7 million increase in net cash used in investing activities was primarily due to the February 2010 purchase of our new headquarters in downtown Washington, D.C., as well as capital improvements for our facilities.

Net cash provided by financing activities was approximately $2.6 million for the nine months ended September 30, 2010, compared to approximately $500,000 for the nine months ended September 30, 2009. The change was due to increased proceeds from exercise of stock options partially offset by increased share repurchases from employees to satisfy employee tax liabilities arising from vesting of restricted stock.

During the nine months ended September 30, 2010, we purchased our new headquarters in Washington, D.C., and incurred capital expenditures of approximately $10.2 million. In addition to the purchase of our new headquarters, we expect to make total capital expenditures in 2010 of approximately $15.0 million to $20.0 million, primarily related to improvements at our facilities.

In connection with the purchase of our new headquarters in Washington, D.C., we assumed the ground lease for the parcel of land under the building. The lease, which expires February 29, 2088, requires the payment of minimum annual rent of $778,000 through February 29, 2012, then approximately $918,000 annually through February 29, 2024. Thereafter, the minimum rate is adjusted to fair market value, as defined in the lease, once every 7 years.

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

To date, we have grown in part by acquiring other companies and we may continue to make acquisitions. Our acquisitions may vary in size and could be material to our current operations. We may use cash, stock, debt or other means of funding to make these acquisitions. In the third quarter of 2009, we issued 572,999 shares of common stock to DMGI, Inc. for all of the issued and outstanding capital stock of PPR and its wholly owned subsidiary. In October 2009, we acquired Resolve Technology for approximately $3.4 million ($2.9 million was paid upon acquisition and $450,000 was deferred until February 2010) in cash and 25,886 shares of CoStar common stock, which had an aggregate value of approximately $1.1 million as of the closing date and are subject to a three-year lockup. Additionally, the seller may be entitled to receive (i) a potential deferred cash payment due approximately two years after closing based on the incremental growth of Resolve Technology's revenue as of September 2011 over its revenue as of September 2009, and (ii) other potential deferred cash payments for successful completion of additional operational and sales milestones during the period from closing through October 31, 2013, which period may be extended by the parties to a date no later than December 31, 2014.

As of September 30, 2010, we had $32.4 million par value of long-term investments in student loan ARS, which failed to settle at auctions. The majority of these investments are of high credit quality with AAA credit ratings and are primarily securities supported by guarantees from the Federal Family Education Loan Program ("FFELP") of the U.S. Department of Education. While we continue to earn interest on these investments, the investments are not liquid in the short-term. In the event we need to immediately access these funds, we may have to sell these securities at an amount below par value. Based on our ability to access our cash, cash equivalents and other short-term investments and our expected operating cash flows, we do not anticipate having to sell these investments below par value in order to operate our business in the foreseeable future.

As described in Footnote 9 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q, on December 23, 2008, we initiated a Financial Industry Regulatory Authority ("FINRA") arbitration against Credit Suisse First Boston ("CSFB") related to CSFB's purchase of ARS for our account. Our complaint asserted breach of contract, fraud, breach of fiduciary duty and other causes of action. In September

2010, the FINRA arbitration panel ruled in favor of CSFB. We did not have a gain or incur a loss as a result of the resolution of this matter.

As described in Footnote 9 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q, we and our wholly owned subsidiary CoStar U.K. Limited were defendants in legal proceedings filed in England by Nokia U.K. Limited ("Nokia") related to a dispute concerning our termination of an agreement to lease certain office space from Nokia. Nokia served its complaint upon us in September 2009. In June 2010, we accrued approximately $2.0 million in anticipation of paying this amount as part of a settlement of this lawsuit. On July 20, 2010, the parties signed a settlement agreement formally resolving this litigation and we subsequently paid approximately $2.0 million to Nokia.

As described in Footnote 9 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q, on December 8, 2009, a former employee filed a lawsuit against us in the United States District Court for the Southern District of California alleging violations of the Fair Labor Standards Act and California state wage-and-hour laws and is seeking unspecified damages under those laws. The complaint also seeks to declare a class of all similarly situated employees to pursue similar claims. In May 2010, the parties reached a preliminary agreement to settle this lawsuit, and in June 2010, we accrued approximately $800,000 in anticipation of making a settlement payment that will formally resolve this litigation. We do not anticipate making any settlement payments until 2011.

Recent Accounting Pronouncements

There have been no developments to the Recent Accounting Pronouncements discussion included in our Annual Report on Form 10-K for the year ended December 31, 2009, including the expected dates of adoption and estimated effects on our consolidated financial statements, except for the following:

In February 2010, the FASB issued authoritative guidance that amends the disclosure requirements related to subsequent events. This guidance includes the definition of a Securities and Exchange Commission filer, removes the definition of a public entity, redefines the reissuance disclosure requirements and allows public companies to omit the disclosure of the date through which subsequent events have been evaluated. This guidance is effective for financial statements issued for interim and annual periods ending after February 2010. This guidance did not materially impact our results of operations or financial position, but did require changes to our disclosures in our financial statements.

In April 2010, the FASB issued authoritative guidance related to the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. A vendor can recognize consideration that is contingent upon achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved if the milestone is: (a) commensurate with either the vendor's performance to achieve the milestone or the enhancement of the value of the item delivered; (b) relates solely to past performance; and (c) is reasonable relative to all deliverables and payment terms in the arrangement. This guidance is effective on a prospective basis for financial statements issued for interim and annual periods ending after June 15, 2010 with early adoption permitted. The adoption of this guidance did not have a material impact on our results of operations or financial position.

Cautionary Statement Concerning Forward-Looking Statements

We have made forward-looking statements in this Report and make forward-looking statements in our press releases and conference calls and other public statements that are subject to risks and uncertainties. Forward-looking statements include information that is not purely historic fact and include, without limitation, statements concerning our financial outlook for the remainder of 2010 and beyond, our possible or assumed future results of operations generally, and other statements and information regarding assumptions about our revenues, EBITDA, adjusted EBITDA, non-GAAP net income, non-GAAP net income per share, fully diluted net income, taxable income, income tax expense, cash flow from operating activities, available cash, operating costs, amortization expense, stock-based compensation expense, intangible asset recovery, net income per share, diluted net income per share, weighted-average outstanding shares, capital and other expenditures, effective tax rate, equity compensation charges, future taxable income, purchase amortization, financing plans, geographic expansion, acquisitions and related costs, restructuring and related costs, headquarters acquisition and related costs, settlements, impairments, contract renewal rate, capital structure, contractual obligations, legal proceedings and claims, our database, database growth, services and facilities, employee relations, future economic performance, our ability to liquidate or realize our long-term investments, management's plans, goals and objectives for future operations, and growth and markets for our stock. Sections of this Report which contain forward-looking statements include the Financial Statements and related Notes, "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Quantitative and Qualitative

Disclosures About Market Risk," "Legal Proceedings" and "Risk Factors."

Our forward-looking statements are also identified by words such as “believes,” “expects,” “thinks,” “anticipates,” “intend “estimates” or similar expressions. You should understand that these forward-looking statements are estimates reflecting our judgment, beliefs and expectations, not guarantees of future performance. They are subject to a number of assumptions, risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the forward-looking statements. The following important factors, in addition to those discussed or referred to under the heading “Risk Factors” in Item 1A. of Part II of this report, and other unforeseen events or circumstances, could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in our forward-looking statements: general economic conditions; commercial real estate market conditions; changes or consolidations within the commercial real estate industry; customer retention; our ability to attract new clients; our ability to sell additional services to existing clients; competition; foreign currency fluctuations; our ability to identify, acquire and integrate potential acquisitions and their respective service offerings; our subsidiaries’ abilities to successfully cross sell our services; our ability to obtain any required financing on favorable terms; global credit market conditions affecting investments; our ability to integrate our U.S. and international product offerings; our ability to continue to expand successfully; our ability to effectively penetrate the market for retail real estate information and gain acceptance in that market; our ability to control costs; litigation; changes in accounting policies or practices; release of new and upgraded services by us or our competitors; data quality; development of our sales force; employee retention; technical problems with our services; managerial execution; changes in relationships with real estate brokers and other strategic partners; legal and regulatory issues; and successful adoption of and training on our services.

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

Item 3.Quantitative and Qualitative Disclosures About Market Risk

We provide information, marketing and analytic services to the commercial real estate and related business community in the U.S., U.K. and France. Our functional currency for our operations in the U.K. and France is the local currency. As such, fluctuations in the British Pound and Euro may have an impact on our business, results of operations and financial position. We currently do not use financial instruments to hedge our exposure to exchange rate fluctuations with respect to our foreign subsidiaries. We may seek to enter hedging transactions in the future to reduce our exposure to exchange rate fluctuations, but we may be unable to enter into hedging transactions successfully, on acceptable terms or at all. As of September 30, 2010, accumulated other comprehensive loss included a loss from foreign currency translation adjustments of approximately $5.3 million.

We do not have material exposure to market risks associated with changes in interest rates related to cash equivalent securities held as of September 30, 2010. As of September 30, 2010, we had $202.6 million of cash, cash equivalents and short-term investments. If there is an increase or decrease in interest rates, there will be a corresponding increase or decrease in the amount of interest earned on our cash, cash equivalents and short-term investments. Based on our ability to access our cash, cash equivalents and short-term investments, and our expected operating cash flows, we do not believe that increases or decreases in interest rates will impact our ability to operate our business in the foreseeable future.

Included within our long-term investments are investments in mostly AAA rated student loan ARS. These securities are primarily securities supported by guarantees from the FFELP of the U.S. Department of Education. As of September 30, 2010, auctions for $32.4 million of our investments in auction rate securities failed. As a result, we

may not be able to sell these investments at par value until a future auction on these investments is successful. In the event we need to immediately liquidate these investments, we may have to locate a buyer outside the auction process, who may be unwilling to purchase the investments at par, resulting in a loss. Based on an assessment of fair value of these investments in ARS as of September 30, 2010, we determined that there was a decline in the fair value of our ARS investments of approximately $3.0 million, which was deemed to be a temporary impairment and recorded as an unrealized loss in accumulated other comprehensive loss in stockholders' equity. If the issuers are unable to successfully close future auctions and/or their credit ratings deteriorate, we may be required to adjust the carrying value of these investments as a temporary impairment and recognize a greater unrealized loss in accumulated other comprehensive loss or as an other-than-temporary impairment charge to earnings. Based on our ability to access our

cash, cash equivalents and short-term investments, and our expected operating cash flows, we do not anticipate having to sell these securities below par value in order to operate our business in the foreseeable future. See Footnotes 4, 5, and 9 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q for further discussion.

We have approximately $100.1 million in intangible assets as of September 30, 2010. As of September 30, 2010, we believe our intangible assets will be recoverable, however, changes in the economy, the business in which we operate and our own relative performance could change the assumptions used to evaluate intangible asset recoverability. In the event that we determine that an asset has been impaired, we would recognize an impairment charge equal to the amount by which the carrying amount of the assets exceeds the fair value of the asset. We continue to monitor these assumptions and their effect on the estimated recoverability of our intangible assets.

Item 4.Controls and Procedures

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

As of September 30, 2010, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

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

PART II — OTHER INFORMATION

Item 1.Legal Proceedings

Currently, and from time to time, we are involved in litigation incidental to the conduct of our business. Certain pending legal proceedings are discussed in Footnote 9 of the Notes to Condensed Consolidated Financial Statements included in Part I of this Quarterly Report on Form 10-Q. We are not currently a party to any material pending legal proceedings.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or results of operations. Other than discussed below, there have been no material changes to the Risk Factors as previously disclosed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2009.

Recent investments in our business may not result in the long-term cost savings we anticipate, and we may incur additional costs in connection with those investments.

We have taken, and may continue to take, actions that may increase our cost structure in the short-term but are intended to reduce certain portions of our long-term cost structure. For example, in February 2010, we purchased a new headquarters building in downtown Washington, D.C., and have since relocated our headquarters to that building and consolidated redundant office space.

If our long-term cost reduction efforts are ineffective or our estimates of cost savings are inaccurate, our profitability could be negatively impacted. Expected savings from relocating facilities can be highly variable and uncertain. Further, we may not be successful in achieving the operating efficiencies or operating cost reductions expected from these efforts in the amounts or at the times we anticipate. Our efforts may not produce the full cost reduction benefits that we currently expect and such benefits, if any, may not be realized when anticipated. For instance, we may not meet the requirements necessary to receive the full property tax abatement provided by the District of Columbia as incentive for us to relocate our headquarters to Washington, D.C. and may incur greater property taxes than anticipated in connection with ownership of our new headquarters.

The costs of implementing these investments may be greater than currently anticipated, and we may experience additional costs in connection with ownership of our headquarters building, relocating offices and consolidation of redundant office space due to delays or other unforeseen circumstances.

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

The following table is a summary of our repurchases of common stock during each of the three months in the quarter ended September 30, 2010:

ISSUER PURCHASES OF EQUITY SECURITIES

| Month | Total Number of Shares Purchased | | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|---|
| July 1 through July 31, 2010 | 2,686 | | $ 39.33 | ¾ | ¾ |
| August 1 through August 31, 2010 | ¾ | | ¾ | ¾ | ¾ |
| September 1 through September 30, 2010 | 2,204 | | $ 42.99 | ¾ | ¾ |
| Total | 4,890 | (1) | $ 40.98 | ¾ | ¾ |

(1) The number of shares purchased consists of shares of common stock tendered by employees to the Company to satisfy the employees' minimum tax withholding obligations arising as a result of vesting of restricted stock grants under the Company's 1998 Stock Incentive Plan, as amended, and the Company's 2007 Stock Incentive Plan, as amended, which shares were purchased by the Company based on their fair market value on the vesting date. None of these share purchases were part of a publicly announced program to purchase common stock of the Company.

Item 3.Defaults upon Senior Securities

None

Item 4.[Removed and Reserved]

Item 5.Other Information

None

Item 6.Exhibits

See exhibits listed under the Exhibit Index below.

SIGNATURES

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

COSTAR GROUP, INC.

| | | |
|---|---|---|
| Date: October 21, 2010 | By: | /s/ Brian J. Radecki<br>Brian J. Radecki<br>Chief Financial Officer<br>(Principal Financial and Accounting Officer and Duly Authorized Officer) |

EXHIBIT INDEX

| Exhibit No. | Description |
|---|---|
| 3.1 | Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 of the Registrant (File No. 333-47953) filed with the Commission on March 13, 1998). |
| 3.2 | Certificate of Amendment of Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999). |
| 3.3 | Amended and Restated By-Laws (Incorporated by Reference to Exhibit 3.3 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2008). |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |