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

FORM 8-K

CURRENT REPORT
Pursuant to Section 13 OR 15(d) of the
Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): June 22, 2007

COSTAR GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation)

0-24531
(Commission
File Number)

52-2091509
(IRS Employer
Identification No.)

2 Bethesda Metro Center, Bethesda, Maryland
(Address of principal executive offices)

20814
(Zip Code)

Registrant's telephone number, including area code (301) 215-8300

Not Applicable
(Former name or former address, if changed since last report.)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

☐ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

☐ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

☐ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

☐ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 5.02. Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers.

The Board of Directors of the Company approved the forms of restricted stock grant and option grant agreements to be used in connection with the Company’s 2007 Stock Incentive Plan. The forms of agreement include provisions that will be determined in connection with actual awards granted under the Plan, including the number of shares subject to the grant, vesting provisions and the exercise prices, as applicable. The form of restricted stock grant agreement is attached hereto as Exhibit 99.1. The forms of incentive stock option grant agreement and nonqualified stock option grant agreement are attached hereto as Exhibits 99.2 and 99.3.

Item 8.01. Other Events.

Segment Reporting

The Company is filing this Current Report on Form 8-K for the purpose of incorporating the contents of this Report in the Registration Statement on Form S-8 that the Company intends to file to register the offering of securities under its 2007 Stock Incentive Plan.

As previously disclosed in the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed with the Commission on May 10, 2007, due to the increased size, complexity and funding requirements associated with the Company’s international expansion in 2007, the Company began to manage the business geographically in two operating segments, with the primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France.

In connection with the new segment presentation adopted in 2007, the Company is updating the following information that appears in its Annual Report on Form 10-K for the year ended December 31, 2006:

- Consent of Independent Registered Public Accounting Firm, attached as Exhibit 23.1 to this report and incorporated herein by reference;
- Part I, Item 1: Business, attached as Exhibit 99.4 to this report and incorporated herein by reference;
- Part II, Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations, attached as Exhibit 99.5 to this report and incorporated herein by reference; and
- Consolidated Financial Statements and Notes, included in Part II, Item 8, attached as Exhibit 99.6 to this report and incorporated herein by reference.

The information included in and with this Current Report on Form 8-K is presented for information purposes only in connection with commencement of segment reporting. There is no change to the Company’s previously reported consolidated operating results, financial condition or cash flows. This Current Report on Form 8-K does not reflect events occurring after February 28, 2007, the date CoStar Group, Inc. filed its Annual Report on Form 10-K for the year ended December 31, 2006, and does not modify or update the disclosures therein in any way, other than as required to reflect the changes in continuing operations and change in segments as described above and set forth in Exhibits 99.4 to 99.6 attached hereto. For information on developments regarding CoStar Group or changes in its business since the filing of the Form 10-K, please refer to the Company’s reports filed with the SEC, including the Company’s Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007.

Item 9.01. Financial Statements and Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
Exhibit 23.1	Consent of Independent Registered Certified Public Accounting firm
Exhibit 99.1	Form of Restricted Stock Grant Agreement
Exhibit 99.2	Form of Incentive Stock Option Grant Agreement
Exhibit 99.3	Form of Nonqualified Stock Option Grant Agreement
Exhibit 99.4	Part I, Item 1 of the Company’s Annual Report on Form 10-K for the year ended December 31, 2006: Business, revised only to reflect segment reporting
Exhibit 99.5	Part II, Item 7 of the Company’s Annual Report on Form 10-K for the year ended December 31, 2006: Management’s Discussion and Analysis of Financial Condition and Results of Operations, revised only to reflect segment reporting

Consolidated Financial Statements and Notes, included in Part II, Item 8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, revised only to reflect segment reporting. Included with the Consolidated Financial Statements is the Report of the Independent Registered Public Accounting firm dated February 19, 2007, except with respect to their opinion on the Company's Consolidated Financial Statements as it relates to the effects of the changes in segments discussed in Note 14, as to which the date is June 22, 2007.

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 hereunto duly authorized.

COSTAR GROUP, INC.

By:

/s/ Brian J. Radecki

Name: Brian J. Radecki

Title: Chief Financial Officer

Date: June 22, 2007

Exhibit Index

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Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in Registration Statements 333-82599, 333-92165, 333-45770, 333-69548, and 333-135709 of our report dated February 19, 2007 (June 22, 2007 as to the change in operating segments described in Note 14) with respect to the consolidated financial statements of CoStar Group, Inc. included in this Current Report on Form 8-K of CoStar Group, Inc. dated June 22, 2007.

/s/ Ernst & Young LLP

McLean, Virginia
June 22, 2007

☐ Participant's Copy

& # 1 6 0 ; ☐ Company's Copy

COSTAR GROUP, INC.
FORM OF RESTRICTED STOCK AGREEMENT
2007 STOCK INCENTIVE PLAN

To: «Name»

CoStar Group, Inc. (the "*Company*") has granted you an award of restricted stock under the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended from time to time (the "*Plan*"), on the terms and conditions set forth below:

1. Grant of Restricted Stock. The Company hereby grants to you «noofshares» shares (the "*Shares*") of common stock of the Company (the "*Common Stock*") at the purchase price of \$0.01 per share (the "*Purchase Price*"), subject to the terms and conditions set forth below (the "*Stock Grant*"). The Date of Grant is «grantdate» (the "*Date of Grant*").
2. Governing Plan. This Stock Grant is subject in all respects to the applicable provisions of the Plan, a copy of the current form of which is attached, except as otherwise noted. By signing this agreement (the "*Agreement*"), you acknowledge that you have received and read the Plan. This Agreement incorporates the Plan by reference and specifies other applicable terms and conditions. All capitalized terms not defined by this Agreement have the meanings given in the Plan. Whenever a conflict may arise between the terms of this Agreement and the terms of the Plan, the terms of the Plan shall control.
3. Lapse of Restrictions. The schedule for the lapse of the restrictions on the Stock Grant is as follows:
- a. The Stock Grant shall vest on the following schedule:

[Set forth vesting schedule. Note that restricted stock awards shall vest no earlier than 3 years from the date of grant for awards not subject to vesting based on performance criteria and 1 year from the date of grant for awards that vest based on achievement of performance criteria.]

In accordance with Section 4 below, any portion of the Stock Grant that has not vested at your termination of employment, consultancy, directorship or other position making you an eligible participant under the Plan will not thereafter vest, unless the Compensation Committee of the Company’s Board of Directors (or other administrator of the Plan, the “Administrator”) determines otherwise.

b. The Stock Grant shall vest immediately upon the occurrence of a Change in Control.

“*Change in Control*” means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of more than 80% of the undiluted total voting power of the Company’s then outstanding securities eligible to vote to elect members of the Board (the “*Company Voting Securities*”);
- ii. consummation of a merger, consolidation or reorganization of the Company with or into any other entity, unless the holders of the Company Voting Securities outstanding immediately before such consummation, together with any trustee or other fiduciary holding securities under a Company benefit plan, hold securities that represent immediately after such merger or consolidation at least 20% of the combined voting power of the then outstanding voting securities of either the Company or the other surviving entity or its parent; or
- iii. the stockholders of the Company approve (A) a plan of complete liquidation or dissolution of the Company or (B) an agreement for the Company’s sale or disposition of all or substantially all of the Company’s assets, *and* such liquidation, dissolution, sale or disposition is consummated.

Even if other tests are met, a Change in Control has not occurred under any circumstances in which the Company files for bankruptcy protection or is reorganized following a bankruptcy filing.

The provisions of Section 5 will also apply if the Change in Control is a Substantial Corporate Change (as defined in those provisions).

- c. The Administrator may, in its sole discretion, accelerate the time at which your Stock Grant shall vest; provided, that, except in the case of a Change in Control or your death or disability, the Stock Grant shall not vest [before the three-year anniversary of the Date of Grant – if not subject to performance criteria] [before the one-year anniversary of the Date of Grant – if subject to achievement of performance criteria].
- d. The vesting period of the Stock Grant may be adjusted by the Administrator to reflect the decreased level of employment during any period in which you are on an approved leave of absence or is employed on a less than full time basis, provided, that the Administrator may take into consideration any accounting consequences to the Company.

4. Termination of Service. Notwithstanding Section 3 above, if your service as a director, officer, employee or consultant (as applicable) of the Company or any of its Subsidiaries is terminated, the Stock Grant shall immediately terminate and be cancelled to the extent it is not vested on the date of your termination, and any Shares subject to this Agreement which have not vested on or before that date shall be forfeited without the payment of any additional consideration.

5. Corporate Change. Upon a Substantial Corporate Change, unless the Board determines otherwise, any unvested portion of the Stock Grant will fully vest unless provision is made in writing in connection with such transaction for:

- a. assumption or continuation of outstanding Stock Grants; or
- b. the substitution for such Stock Grants, with appropriate adjustments as to the number and kind of shares of stock and prices, in which event the Stock Grant will continue in the manner and under the terms so provided.

A "*Substantial Corporate Change*" means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of 100% of the combined voting power of all classes of stock of the Company;
- ii. merger, consolidation or reorganization of the Company with or into one or more entities in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly owned subsidiary, a reincorporation of the Company in a different jurisdiction or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings);
- iii. merger, consolidation or reorganization of the Company in which the Company is the surviving corporation, but after which the stockholders of the Company immediately prior to such merger (other than any stockholder that merges, or which owns or controls another corporation that merges, with the Company in such merger) cease to own their shares or other equity interest in the Company;
- iv. the liquidation or dissolution of the Company; or

v. the sale or disposition of all or substantially all of the Company's assets.

6. Restriction on Sale or Other Transfer. You shall not sell, pledge, assign, transfer, hypothecate or otherwise dispose of any unvested portion of the Stock Grant, and such unvested portion of the Stock Grant shall not be subject to execution, attachment or similar legal process. Any attempt to sell, pledge, assign, transfer, hypothecate or otherwise dispose of any unvested portion of the Stock Grant, or to subject such unvested portion of the Stock Grant to execution, attachment or similar legal process, shall be null and void.

7. Procedure for Issuance of Shares. Following the Date of Grant, the Company will issue stock certificates in your name for the Shares, but the stock certificates will remain in the Company's custody, and the stock certificates will contain a legend describing the restrictions set forth in this Agreement. As soon as practicable after all or any portion of the Stock Grant has vested as provided in Section 3 or 5, the Company shall issue new stock certificates for those Shares, provided that

- a. you have complied with any requests for representations under the Plan;
- b. the Company has received proof satisfactory to the Company that a person seeking to receive the Shares after your death or disability is authorized and entitled to receive the Shares; and
- c. you have satisfied any federal, state, or local tax withholding obligations.

The Company will round down any fractional Shares but will not make any cash or other payments in settlement of fractional shares eliminated by rounding. If the Stock Grant has not then fully vested, the Company will carry forward the fractional Shares rather than eliminating them. Notwithstanding the foregoing, the Company, in its sole discretion, may also use alternatives to issuing physical stock certificates, such as "book entry only" recordation.

8. Compliance with Securities Laws. Upon the acquisition of any Shares pursuant to this Agreement, you shall enter into such written representations, warranties and agreements as the Company may reasonably request in order to comply with applicable securities laws or this Agreement. Nothing herein obligates the Company to register or qualify the Shares pursuant to any federal or state securities laws.

9. Compliance with Laws. Notwithstanding any of the other provisions hereof, you agree that the Company will not be obligated to issue any Shares pursuant to this Agreement, if issuing the Shares would violate any provision of any law or regulation of any governmental authority. Notwithstanding anything to the contrary in Section 7, the certificates representing the Shares of Common Stock issued pursuant to this Agreement will be stamped or otherwise imprinted with legends in such form as the Company may require with respect to any applicable restrictions on sale or transfer.

10. Voting and Other Rights. Subject to the provisions of the Plan and this Agreement, you shall have all of the powers, preferences, and rights of a holder of Common Stock with respect to the Shares comprising the Stock Grant, including the right to vote the Shares and the right to dividends and other distributions, if any. You agree and understand that nothing

contained in this Agreement provides, or is intended to provide, you any protection against potential future dilution of your stockholder interest in the Company for any reason, except as otherwise stated within the Plan. Any stock dividends paid in respect of any unvested portion of the Stock Grant will be subject to the same restrictions and other terms and conditions that apply to the underlying Shares with respect to which such stock dividends are issued.

11. Restrictions on Resales. The Company may impose such restrictions, conditions or limitations as it determines appropriate as to the timing and manner of any resales by you or other subsequent transfers by you of any shares of Common Stock issued as a result of the vesting of a Stock Grant, including without limitation (a) restrictions under an insider trading policy and (b) restrictions as to the use of a specified brokerage firm for such resales or other transfers.

12. Not an Employment Contract. Nothing in this Agreement restricts the right of the Company or any of its affiliates to terminate your employment at any time, with or without cause. The termination of employment, whether by the Company or any of its affiliates or otherwise, and regardless of the reason therefore, has the consequences provided for hereunder, under the Plan and under any applicable employment or severance agreement.

13. Non-Transferability of Stock Grant. You may not assign or transfer the Stock Grant to anyone other than by will or the laws of descent and distribution until the Shares become vested in accordance with Section 3 or 5 hereof. The Company may cancel the Stock Grant if you attempt to assign or transfer it in a manner inconsistent with this Section 13.

14. Withholding of Tax and Section 83(b) Election.

- a. You understand and agree that the Company has not advised you regarding your income tax liability in connection with the grant or vesting of the Stock Grant. You understand that you (and not the Company) shall be solely responsible for your own tax liability that may arise as a result of the transactions contemplated by this Agreement. The grant and vesting of the Stock Grant shall be subject to all applicable income and employment tax withholdings. The Company may refuse to release the restriction on any Shares to you until you satisfy all applicable tax withholding obligations. You acknowledge that the Company has the right, in its discretion, to deduct and retain without notice from shares issuable upon vesting of the Stock Grant (or any portion thereof) or, unless otherwise determined by the Administrator, from salary or other amounts payable to you, shares or cash having a value sufficient to satisfy the tax withholding obligations.
- b. To the extent required by applicable federal, state, local or foreign law, you shall make arrangements satisfactory to the Company in its sole discretion for the satisfaction of any withholding tax obligations that arise by reason of vesting of the Stock Grant or disposition of shares issued as a result of such vesting. By accepting the Stock Grant, you agree that, unless and to the extent you have otherwise satisfied your tax withholding obligations in a manner permitted or required by the Administrator pursuant to the Plan, the Company is authorized (but not required) to deduct and retain without notice from the Shares in respect of the vested portion of the Stock Grant the whole number of shares (rounding down) having a Fair Market Value on the vesting date or, if not a trading day, the first trading day before the vesting date (as determined by the Company consistent with any applicable tax requirements) sufficient to satisfy the applicable Tax Withholding Obligation. If the withheld shares are not sufficient to satisfy your Tax Withholding Obligation, you agree to pay to the Company as soon as practicable, by cash or check or, unless otherwise determined by the Administrator, deducted from salary or other amounts payable to you, any amount of the Tax Withholding Obligation that is not satisfied by the withholding of shares of Common Stock described above. Furthermore, the Company shall have the right to deduct and withhold any such applicable taxes from, or in respect of, any dividends or other distributions paid on or in respect of the Common Stock comprising the Stock Grant.

- c. You are ultimately liable and responsible for all taxes owed by you in connection with the Stock Grant, regardless of any action the Company takes or any transaction pursuant to this Section 14 with respect to any tax withholding obligations that arise in connection with the Stock Grant. The Company makes no representation or undertaking regarding the treatment of any tax withholding in connection with the grant, issuance, or vesting of the Stock Grant or the subsequent sale of any of the shares of Common Stock acquired upon vesting of the Stock Grant. The Company does not commit and is under no obligation to structure the Stock Grant to reduce or eliminate your tax liability.
- d. You understand that Section 83(a) of the Internal Revenue Code of 1986, as amended (the “Code”), taxes as ordinary income the difference between (i) the amount (if any) paid for the Shares, and (ii) the fair market value of the Shares on the date any restrictions on the Shares lapse. You further understand that you may elect to be taxed at the time the Shares are granted rather than when the applicable restrictions lapse by filing an election under Section 83(b) of the Code with the U.S. Internal Revenue Service within 30 days from the date of purchase of the Shares. You shall notify the Company of your intention to make an election under Section 83(b) of the Code at least five (5) business days before making such election and promptly provide a copy of such election to the Company.

[NOTE: THE DIRECTOR FORM OF RESTRICTED STOCK GRANT WILL NOT HAVE THE PROVISIONS SET OUT IN THIS SECTION 14. INSTEAD, SECTION 14 IN THE DIRECTOR FORM WILL READ AS FOLLOWS: “All taxes, if any, in respect of the Stock Grant or any payments to you hereunder shall be solely your responsibility and shall be paid by you.”]

15. Extraordinary Corporate Transactions. You understand and agree that the existence of this Stock Grant will not affect in any way the right or power of the Company or its stockholders to make or authorize any or all adjustments, recapitalizations, reorganizations, or other changes in the Company's capital structure or its business or any merger or consolidation of the Company, or any issuance of bonds, debentures, preferred or other stocks with preference ahead of or convertible into, or otherwise affecting the Common Stock or the rights thereof, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.

16. Resolution of Disputes. As a condition of this Stock Grant, you, on behalf of yourself, your heirs, successors and personal representatives ("*you and your successors*"), agree that any dispute or disagreement which may arise hereunder shall be decided by the Administrator. You and your successors agree to accept as binding, conclusive and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Stock Grant, and you and your successors hereby explicitly waive any right to judicial review.

17. Payment of Purchase Price. If required by law, as a condition of this Stock Grant, you hereby authorize the Company to set-off from any salary, wages, bonus or other monies owed to you by the Company or any of its affiliates, the Purchase Price for the Stock Grant.

18. General.

- a. This Agreement and the Plan constitute the entire understanding between you and the Company regarding the Stock Grant. Any prior agreements, commitments or negotiations concerning the Stock Grant are superseded.
- b. The laws of the State of Delaware will govern all matters relating to this Agreement, without regard to the principles of conflict of laws.
- c. Any notice you give to the Company must be in writing and either hand-delivered or mailed to the Corporate Secretary of the Company (or to the Chief Financial Officer if either you would receive the notice or the position is vacant). If mailed, it should be sent by certified mail and be addressed to the foregoing executive at the Company's then corporate headquarters. Any notice given to you will be addressed to you at your address as reflected on the personnel records of the Company. You may change the address for notice by like notice to the Company. Notice will be deemed to have been duly delivered when hand-delivered, or, if mailed, two business days after such notice is postmarked.
- d. In the event that any provision of this Agreement is declared to be illegal, invalid or otherwise unenforceable by a court of competent jurisdiction, such provision shall be reformed, if possible, to the extent necessary to render it legal, valid and enforceable, or otherwise deleted, and the remainder of the terms hereunder shall not be affected except to the extent necessary to reform or delete such illegal, invalid or unenforceable provision.
- e. This Agreement shall inure to the benefit of and be binding upon the parties hereto and their respective permitted heirs, beneficiaries, successors and assigns.

- f. The headings preceding the text of the sections hereof are inserted solely for convenience of reference, and shall not constitute a part of this Agreement, nor shall they affect its meaning, construction or effect.
- g. All questions arising under the Plan or under this Agreement shall be decided by the Administrator in its total and absolute discretion.

;

COSTAR GROUP, INC.

By _____
Name: _____
Title: _____

ACKNOWLEDGMENT

I acknowledge receipt of a copy of the attached Plan. I represent that I have read and am familiar with the Plan's terms. I accept the Stock Grant subject to all of the terms and provisions of this Agreement and of the Plan under which it is granted, as the Plan may be amended in accordance with its terms. I agree to accept as binding, conclusive, and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Stock Grant.

Date: _____
Signature of Stock Grantee _____

No one may sell, transfer, or distribute this Stock Grant or the securities that may be issued in connection with this Stock Grant without an effective registration statement relating thereto or an opinion of counsel satisfactory to the Company or other information and representations satisfactory to the Company that such registration is not required.

☐ Company's Copy

& # 1 6 0 ;

☐ Grantee's Copy

COSTAR GROUP, INC.
2007 STOCK INCENTIVE PLAN
FORM OF INCENTIVE STOCK OPTION AGREEMENT

To «Name»:

CoStar Group, Inc. (the "*Company*") has granted you an option (the "*Option*") under the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended from time to time (the "*Plan*"), to purchase «NoShares» shares (the "*Shares*") of common stock of the Company (the "*Common Stock*"), at «Price» per share (the "*Exercise Price*"). The date of grant is «DateofGrant».

This Option is subject in all respects to the applicable provisions of the Plan, a copy of which is attached, except as otherwise noted. By signing this agreement (the "*Agreement*"), you acknowledge that you have received and read the Plan. This Agreement incorporates the Plan by reference and specifies other applicable terms and conditions. All capitalized terms not defined by this Agreement have the meanings given in the Plan. The Compensation Committee of the Company's Board of Directors (or other administrator of the Plan, the "*Administrator*") may adjust the number of Shares and the Exercise Price with respect to your Option from time to time in accordance with the Plan.

Subject to the terms of the Plan, the Option is intended to be an incentive stock option within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended (the "*Code*"), and will be interpreted accordingly; provided, however that the Option will be an incentive stock option only to the extent that the aggregate Fair Market Value (determined at the date of grant) of the stock with respect to which incentive stock options are exercisable for the first time by you during any calendar year (under the Plan and all other plans of the Company and its subsidiary corporations, within the meaning of Code Section 422(d)), does not exceed \$100,000. This limitation will be applied by taking Options into account in the order in which such Options were granted. If, by design or operation, the Option exceeds this limit, the excess will be treated as a nonqualified stock option.

[Alternative for ISO/NQSO hybrid grant:

Subject to the terms of the Plan, the Option is intended to be an incentive stock option within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"), and a nonqualified stock option with respect to the following number of shares for which the Option first becomes exercisable (and will be interpreted accordingly):

[Insert]

Notwithstanding the foregoing, the Option will be an incentive stock option only to the extent that the aggregate Fair Market Value (determined at the date of grant) of the stock with respect to which incentive stock options are exercisable for the first time by you during any calendar year (under the Plan and all other plans of the Company and its subsidiary corporations, within the meaning of Code Section 422(d)), does not exceed \$100,000. This limitation will be applied by taking Options into account in the order in which such Options were granted. If, by design or operation, the Option exceeds this limit, the excess will be treated as a nonqualified stock option.]

In addition to the terms, conditions, and restrictions set forth in the Plan, the following terms, conditions, and restrictions apply to the Option:

(1) Vesting. The schedule for exercising the Option is as follows, subject to the expiration provisions set forth in Section 3 below:

a. You may exercise the Option on the following schedule:

[Set forth vesting schedule. Note, that options are subject to a minimum one year vesting period.]

No portion of the Option that is unexercisable at your termination of employment will thereafter become exercisable, unless the Administrator determines otherwise.

b. The Option will become immediately exercisable in full upon the occurrence of a Change in Control.

“Change in Control” means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of more than 80% of the undiluted total voting power of the Company’s then outstanding securities eligible to vote to elect members of the Board (the “Company Voting Securities”);

ii. consummation of a merger, consolidation or reorganization of the Company with or into any other entity, unless the holders of the Company Voting Securities outstanding immediately before such consummation, together with any trustee or other fiduciary holding securities under a Company benefit plan, hold securities that represent immediately after such merger or consolidation at least 20% of the combined voting power of the then outstanding voting securities of either the Company or the other surviving entity or its parent; or

iii. the stockholders of the Company approve (A) a plan of complete liquidation or dissolution of the Company or (B) an agreement for the Company's sale or disposition of all or substantially all of the Company's assets, *and* such liquidation, dissolution, sale or disposition is consummated.

Even if other tests are met, a Change in Control has not occurred under any circumstances in which the Company files for bankruptcy protection or is reorganized following a bankruptcy filing.

The provisions of Section 4 will also apply if the Change in Control is a Substantial Corporate Change (as defined in those provisions).

c. The Administrator may, in its sole discretion, accelerate the time at which you may exercise part or all of the Option; provided, that, except in the case of a Change in Control or your death or disability (as defined in Section 3(d) below), the Option may not vest before the one-year anniversary of the date of grant.

d. The vesting period and/or exercisability of the Option may be adjusted by the Administrator to reflect the decreased level of employment during any period in which you are on an approved leave of absence or employed on a less than full time basis, provided, that the Administrator may take into consideration any accounting consequences to the Company.

(2) Exercise. Subject to this Agreement and the Plan, unless the Administrator determines otherwise, you may exercise the Option only by a written "Notice of Exercise" to the Company or its designee on a form specified by the Company on or before the date the Option expires. Unless the Administrator determines otherwise, each such Notice must:

- a. state your election to exercise the Option and the number of Shares with respect to which you are exercising the Option;
- b. be signed by you or, if you have died or become disabled, by the party entitled to exercise the Option;
- c. contain such representations as the Company reasonably requires; and
- d. be accompanied by payment of the Exercise Price in full through one, or a combination, of the following payment methods, which method(s) shall be indicated in the Notice of Exercise:
 - i. cashier's or certified check in the amount of the Exercise Price payable to the order of the Company;
 - ii. direction to the Company through your Notice of Exercise to send the share certificates to be issued under this Option to a licensed broker acceptable to the Company as your agent in exchange for the broker's tendering to the Company cash (or acceptable cash equivalents) equal to the Exercise Price, for the Shares with respect to which the Option is being exercised, as part of a cashless exercise;
 - iii. unless the Administrator determines otherwise, by surrender to the Company of shares of Common Stock with a Fair Market Value on the date of exercise equal to all or part of the Exercise Price (with any balance paid by cash or check or, unless the Administrator determines otherwise, deducted from salary or other amounts payable to you), for the Shares with respect to which the Option is being exercised; provided, however, that you may not surrender (turn in) previously held or owned Common Stock of the Company as payment unless you have held such stock for more than six months before the surrender. For purposes hereof, the date of exercise shall be the date of delivery of (A) the duly executed Notice of Exercise and (B) the shares tendered for payment of the Exercise Price;
 - iv. unless the Administrator determines otherwise, attestation of ownership of Common Stock and issuance of a net number of shares upon Option exercise; or

- v. unless the Administrator determines otherwise, by the Company withholding from the shares of Common Stock otherwise issuable to you upon the exercise of the Option (or portion thereof) the whole number of shares with a Fair Market Value on the date of exercise equal to all or part of the Exercise Price (rounded down, with any balance paid by cash or check or, unless the Administrator determines otherwise, deducted from salary or other amounts payable to you on such date of exercise). For purposes hereof, the date of exercise shall be the date of delivery of the duly executed Notice of Exercise.

The Company shall not be obligated to issue any shares of Common Stock until you have paid the total Exercise Price for that number of shares of Common Stock you have elected to purchase. Shares of Common Stock will be issued as soon as is practical after exercise.

(3) Expiration. The Option will expire no later than the close of business on «ExpirationDate» (ten years from the date of grant or five years for an ISO granted to a more-than 10% stockholder on the date of grant).

Unless the Administrator determines otherwise at any time, you will forfeit any unexercised portions of the Option (whether or not then exercisable) upon the first to occur of:

- a. the Option's expiration under the preceding sentence,
- b. the 90th day after your resignation, including retirement (for any reason other than disability),
- c. the 90th day after the Company terminates your employment (for any reason other than disability),
- d. in the event of the termination of your employment for disability (as determined by the Administrator), the earlier of (i) the first anniversary of the termination of your employment and (ii) 30 days after you cease to have a disability, where, for purposes of this Agreement, “*disability*” means the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than twelve months,
- e. the first anniversary of your date of death, and
- f. the date you violate any covenant not to compete, nonsolicitation covenant or similar covenant in effect between you and the Company.

The Administrator, in its sole discretion, will determine all questions of whether particular terminations or leaves of absence are terminations of employment for purposes of this Agreement.

If you exercise an Option more than 90 days after termination of employment with the Company, you will only receive incentive stock option treatment to the extent provided under the Code, and becoming or remaining an employee of another related company (that is not a Subsidiary) or an independent contractor to the Company will not prevent loss of incentive stock option status as a result of the formal termination of employment unless otherwise provided under the Code.

(4) **Substantial Corporate Change.** Upon a Substantial Corporate Change, any portion of this Option that is unexercised will terminate unless provision is made in writing in connection with such transaction for:

- a. assumption or continuation of outstanding Options; or
- b. the substitution for such Options, with appropriate adjustments as to the number and kind of shares of stock and prices, in which event the Option will continue in the manner and under the terms so provided.

Unless the Board determines otherwise, if an Option would otherwise terminate pursuant to the preceding sentence, you will have the right, at such time before the consummation of the transaction causing such termination as the Board reasonably designates, to exercise any unexercised portions of the Option, whether or not previously exercisable.

A “*Substantial Corporate Change*” means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of 100% of the combined voting power of all classes of stock of the Company;
- ii. merger, consolidation or reorganization of the Company with or into one or more entities in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly owned subsidiary, a reincorporation of the Company in a different jurisdiction or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings);

iii. merger, consolidation or reorganization of the Company in which the Company is the surviving corporation, but after which the stockholders of the Company immediately prior to such merger (other than any stockholder that merges, or which owns or controls another corporation that merges, with the Company in such merger) cease to own their shares or other equity interest in the Company;

iv. the liquidation or dissolution of the Company; or

v. the sale or disposition of all or substantially all of the Company's assets.

(5) Taxes.

- a. You understand and agree that the Company has not advised you regarding your income tax liability in connection with the Option. To the extent required by applicable federal, state, local or foreign law, you shall make arrangements satisfactory to the Company in its sole discretion for the satisfaction of any withholding tax obligations that arise by reason of an Option exercise or disposition of shares issued as a result of an Option exercise. The Company shall not be required to issue shares or to recognize the disposition of such shares until such obligations are satisfied.
- b. By accepting the Option, you agree that, unless and to the extent you have otherwise satisfied any U.S. federal income and other taxes, including state, local or non-U.S. income or employment tax obligations, related to the exercise of the Option that are required to be withheld and paid over to the applicable tax authorities (the "*Tax Withholding Obligations*") in a manner permitted or required by the Administrator pursuant to the Plan, the Company is authorized (but not required) to deduct and retain without notice from the shares of Common Stock issuable to you in respect of the exercised portion of the Option the whole number of shares (rounding down) having a Fair Market Value on the exercise date or, if not a trading day, the first trading day before the exercise date (as determined by the Company consistent with any applicable tax requirements) sufficient to satisfy the applicable Tax Withholding Obligation. If the withheld shares are not sufficient to satisfy your Tax Withholding Obligation, you agree to pay to the Company as soon as practicable, by cash or check or, unless otherwise determined by the Administrator, deducted from salary or other amounts payable to you, any amount of the Tax Withholding Obligation that is not satisfied by the withholding of shares of Common Stock described above.

c. You are ultimately liable and responsible for all taxes owed by you in connection with the Option, regardless of any action the Company takes or any transaction pursuant to this Section 5 with respect to any tax withholding obligations that arise in connection with the Option. The Company makes no representation or undertaking regarding the treatment of any tax withholding in connection with the grant, issuance, vesting or exercise of the Option or the subsequent sale of any of the shares of Common Stock acquired upon exercise of the Option. The Company does not commit and is under no obligation to structure the Option to reduce or eliminate your tax liability.

(6) Company Postponement of Delivery. The Company may postpone issuing and delivering any Shares for so long as the Company determines to be necessary or advisable to satisfy the following:

- a. completing or amending any registration or qualification of the Shares or satisfying any exemption from registration under any federal or state law, rule, or regulation;
- b. complying with any requests for representations under the Plan;
- c. receiving proof satisfactory to the Company that a person seeking to exercise the Option after your death or disability is authorized and entitled to exercise the Option; and
- d. satisfying any federal, state, or local tax withholding obligations.

(7) Compliance with Securities Laws.

- a. If, at the time the Company should issue you Shares because of your exercise of the Option, no current registration statement under the Securities Act of 1933 (the "Act") covers such issuance, you must, before the Company will issue such Shares to you:
 - i. represent to the Company, in form satisfactory to the Company's counsel, that you are acquiring the Shares for your own account and not with a view to reselling or distributing the Shares; and

ii. agree that you may not sell, transfer, or otherwise dispose of the Shares issued to you under the Option unless:

- A. a registration statement under the Act is effective at the time of disposition with respect to the Shares sold, transferred, or otherwise disposed of; or
- B. the Company has received an opinion of counsel or other information and representations satisfactory to it to the effect that registration under the Act is not required by reason of Rule 144 under the Act or otherwise.

b. Notwithstanding anything herein to the contrary, you may not exercise the Option, and the Company shall not be obligated to deliver any shares of Common Stock, during any period when the Company determines that the exercisability of the Option or the delivery of shares hereunder would violate any applicable federal or state securities laws or other laws or regulations.

- (8) Restrictions on Resales. The Company may impose such restrictions, conditions or limitations as it determines appropriate as to the timing and manner of any resales by you or other subsequent transfers by you of any shares of Common Stock issued as a result of the exercise of the Option, including without limitation (a) restrictions under an insider trading policy, (b) restrictions designed to delay and/or coordinate the timing and manner of sales by you and other optionholders and (c) restrictions as to the use of a specified brokerage firm for such resales or other transfers.
- (9) Not an Employment Contract. Nothing in this Agreement restricts the right of the Company or any of its affiliates to terminate your employment at any time, with or without cause. The termination of employment, whether by the Company or any of its affiliates or otherwise, and regardless of the reason therefore, has the consequences provided for hereunder, under the Plan and under any applicable employment or severance agreement.
- (10) Non-Transferability of Option. You may not assign or transfer the Option to anyone other than by will or the laws of descent and distribution and the Option shall be exercisable only by you during your lifetime. The Company may cancel the Option if you attempt to assign or transfer it in a manner inconsistent with this Section 10.

- (11) Limitation of Interest. You understand and agree that you will not be deemed for any purpose to be a stockholder of the Company with respect to any of the Shares unless and until they have been issued to you after your exercise of this Option and payment for the Shares. Neither you (individually or as a member of a group) nor any beneficiary or other person claiming under or through you shall have any right, title, interest, or privilege in or to any shares of Common Stock allocated or reserved for the purpose of the Plan or subject to this Agreement except as to such shares of Common Stock, if any, as shall have been issued to such person upon exercise of the Option or any part of it.
- (12) No Fractional Shares. At the time of exercise, the Company will round down any fractional Shares but will not make any cash or other payments in settlement of fractional shares eliminated by rounding. If you have not then exercised the Option in full, the Company will carry forward the fractional Shares rather than eliminating them.
- (13) No Limitation on Company Actions. You understand and agree that the existence of this Option will not affect in any way the right or power of the Company or its stockholders to make or authorize any or all adjustments, recapitalizations, reorganizations, or other changes in the Company's capital structure or its business or any merger or consolidation of the Company, or any issuance of bonds, debentures, preferred or other stocks with preference ahead of or convertible into, or otherwise affecting the Common Stock or the rights thereof, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.
- (14) General.
- a. This Agreement and the Plan constitute the entire understanding between you and the Company regarding the Option. Any prior agreements, commitments or negotiations concerning the Option are superseded.
 - b. The laws of the State of Delaware will govern all matters relating to this Agreement, without regard to the principles of conflict of laws.
 - c. Any notice you give to the Company (including notice of exercise of all or part of the Option) must be in writing and either hand-delivered or mailed to the Corporate Secretary of the Company (or to the Chief Financial Officer if either you would receive the notice or the position is vacant). If mailed, it should be sent by certified mail and be addressed to the foregoing executive at the Company's then corporate headquarters. Any notice given to you will be addressed to you at your address as reflected on the personnel records of the Company. You may change the address for notice by like notice to the Company. Notice will be deemed to have been duly delivered when hand-delivered, or, if mailed, two business days after such notice is postmarked.

- d. As a condition of this Option, you, on behalf of yourself, your heirs, successors and personal representatives ("*you and your successors*"), agree that any dispute or disagreement which may arise hereunder shall be decided by the Administrator. You and your successors agree to accept as binding, conclusive and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Option, and you and your successors hereby explicitly waive any right to judicial review.
- e. In the event that any provision of this Agreement is declared to be illegal, invalid or otherwise unenforceable by a court of competent jurisdiction, such provision shall be reformed, if possible, to the extent necessary to render it legal, valid and enforceable, or otherwise deleted, and the remainder of the terms hereunder shall not be affected except to the extent necessary to reform or delete such illegal, invalid or unenforceable provision.
- f. This Agreement shall inure to the benefit of and be binding upon the parties hereto and their respective permitted heirs, beneficiaries, successors and assigns.
- g. The headings preceding the text of the sections hereof are inserted solely for convenience of reference, and shall not constitute a part of this Agreement, nor shall they affect its meaning, construction or effect.
- h. All questions arising under the Plan or under this Agreement shall be decided by the Administrator in its total and absolute discretion.
- i. Wherever a conflict may arise between the terms of this Agreement and the terms of the Plan, the terms of the Plan will control.

□ 0;

By:

Name:

Title:

COSTAR GROUP, INC.

11

ACKNOWLEDGMENT

I acknowledge receipt of a copy of the attached Plan. I represent that I have read and am familiar with the Plan's terms. I accept the Option subject to all of the terms and provisions of this Agreement and of the Plan under which it is granted, as the Plan may be amended in accordance with its terms. I agree to accept as binding, conclusive, and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Option.

Date:

Signature of Grantee/Participant

No one may sell, transfer, or distribute this Option or the securities that may be purchased upon exercise of this Option without an effective registration statement relating thereto or an opinion of counsel satisfactory to the Company or other information and representations satisfactory to the Company that such registration is not required.

- ☐ Grantee's Copy
- ☐ Company's Copy

COSTAR GROUP, INC.
2007 STOCK INCENTIVE PLAN
FORM OF NONQUALIFIED STOCK OPTION AGREEMENT

To «Name»:

CoStar Group, Inc. (the "*Company*") has granted you a nonqualified stock option (the "*Option*") under the CoStar Group, Inc. 2007 Stock Incentive Plan, as amended from time to time (the "*Plan*"), to purchase «NoShares» shares (the "*Shares*") of common stock of the Company (the "*Common Stock*"), at «Price» per share (the "*Exercise Price*"). The date of grant is «DateofGrant».

This Option is subject in all respects to the applicable provisions of the Plan, a copy of which is attached, except as otherwise noted. By signing this agreement (the "*Agreement*"), you acknowledge that you have received and read the Plan. This Agreement incorporates the Plan by reference and specifies other applicable terms and conditions. All capitalized terms not defined by this Agreement have the meanings given in the Plan. The Compensation Committee of the Company's Board of Directors (or other administrator of the Plan, the "*Administrator*") may adjust the number of Shares and the Exercise Price with respect to your Option from time to time in accordance with the Plan.

This Option is not intended to be an incentive stock option under Section 422 of the Internal Revenue Code of 1986, as amended, and will be interpreted accordingly.

In addition to the terms, conditions, and restrictions set forth in the Plan, the following terms, conditions, and restrictions apply to the Option:

(1) Vesting. The schedule for exercising the Option is as follows, subject to the expiration provisions set forth in Section 3 below:

- a. You may exercise the Option on the following schedule:

[Set forth vesting schedule. Note, that options are subject to a minimum one year vesting period.]

No portion of the Option that is unexercisable at your termination of employment, consultancy, directorship or other position making you an eligible participant under the Plan will thereafter become exercisable, unless the Administrator determines otherwise.

b. The Option will become immediately exercisable in full upon the occurrence of a Change in Control.

“*Change in Control*” means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of more than 80% of the undiluted total voting power of the Company’s then outstanding securities eligible to vote to elect members of the Board (the “*Company Voting Securities*”);
- ii. consummation of a merger, consolidation or reorganization of the Company with or into any other entity, unless the holders of the Company Voting Securities outstanding immediately before such consummation, together with any trustee or other fiduciary holding securities under a Company benefit plan, hold securities that represent immediately after such merger or consolidation at least 20% of the combined voting power of the then outstanding voting securities of either the Company or the other surviving entity or its parent; or
- iii. the stockholders of the Company approve (A) a plan of complete liquidation or dissolution of the Company or (B) an agreement for the Company’s sale or disposition of all or substantially all of the Company’s assets, *and* such liquidation, dissolution, sale or disposition is consummated.

Even if other tests are met, a Change of Control has not occurred under any circumstances in which the Company files for bankruptcy protection or is reorganized following a bankruptcy filing.

The provisions of Section 4 will also apply if the Change in Control is a Substantial Corporate Change (as defined in those provisions).

- c. The Administrator may, in its sole discretion, accelerate the time at which you may exercise part or all of the Option; provided, that, except in the case of a Change in Control or your death or disability (as defined in Section 3(d) below), the Option may not vest before the one-year anniversary of the date of grant.
 - d. The vesting period and/or exercisability of the Option may be adjusted by the Administrator to reflect the decreased level of employment or other applicable service during any period in which you are on an approved leave of absence or employed or providing applicable services on a less than full time basis, provided, that the Administrator may take into consideration any accounting consequences to the Company.
- (2) Exercise. Subject to this Agreement and the Plan, unless the Administrator determines otherwise, you may exercise the Option only by a written "Notice of Exercise" to the Company or its designee on a form specified by the Company on or before the date the Option expires. Unless the Administrator determines otherwise, each such Notice must:
- a. state your election to exercise the Option and the number of Shares with respect to which you are exercising the Option;
 - b. be signed by you or, if you have died or become disabled, by the party entitled to exercise the Option;
 - c. contain such representations as the Company reasonably requires; and
 - d. be accompanied by payment of the Exercise Price in full through one, or a combination, of the following payment methods, which method(s) shall be indicated in the Notice of Exercise:
 - i. cashier's or certified check in the amount of the Exercise Price payable to the order of the Company;
 - ii. direction to the Company through your Notice of Exercise to send the share certificates to be issued under this Option to a licensed broker acceptable to the Company as your agent in exchange for the broker's tendering to the Company cash (or acceptable cash equivalents) equal to the Exercise Price, for the Shares with respect to which the Option is being exercised, as part of a cashless exercise;

iii. unless the Administrator determines otherwise, by surrender to the Company of shares of Common Stock with a Fair Market Value on the date of exercise equal to all or part of the Exercise Price (with any balance paid by cash or check or, unless the Administrator determines otherwise, deducted from salary or other amounts payable to you), for the Shares with respect to which the Option is being exercised; provided, however, that you may not surrender (turn in) previously held or owned Common Stock of the Company as payment unless you have held such stock for more than six months before the surrender. For purposes hereof, the date of exercise shall be the date of delivery of (A) the duly executed Notice of Exercise and (B) the shares tendered for payment of the Exercise Price;

iv. unless the Administrator determines otherwise, attestation of ownership of Common Stock and issuance of a net number of shares upon Option exercise; or

v. unless the Administrator determines otherwise, by the Company withholding from the shares of Common Stock otherwise issuable to you upon the exercise of the Option (or portion thereof) the whole number of shares with a Fair Market Value on the date of exercise equal to all or part of the Exercise Price (rounded down, with any balance paid by cash or check or, unless the Administrator determines otherwise, deducted from salary or other amounts payable to you on such date of exercise). For purposes hereof, the date of exercise shall be the date of delivery of the duly executed Notice of Exercise.

The Company shall not be obligated to issue any shares of Common Stock until you have paid the total Exercise Price for that number of shares of Common Stock you have elected to purchase. Shares of Common Stock will be issued as soon as is practical after exercise.

(3) Expiration. The Option will expire no later than the close of business on «ExpirationDate» (ten years from the date of grant).

Unless the Administrator determines otherwise at any time, you will forfeit any unexercised portions of the Option (whether or not then exercisable) upon the first to occur of:

a. the Option's expiration under the preceding sentence,

- b. the 90th day after your resignation, including retirement (for any reason other than disability),
- c. the 90th day after the Company terminates your employment or other applicable service (for any reason other than disability),
- d. in the event of the termination of your employment or other applicable service to the Company for disability (as determined by the Administrator), the earlier of (i) the first anniversary of the termination of your service and (ii) 30 days after you cease to have a disability, where, for purposes of this Agreement, “*disability*” means the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than twelve months,
- e. the first anniversary of your date of death, and
- f. the date you violate any covenant not to compete, nonsolicitation covenant or similar covenant in effect between you and the Company.

The Administrator, in its sole discretion, will determine all questions of whether particular terminations or leaves of absence are terminations of employment or other applicable service for purposes of this Agreement.

(4) Substantial Corporate Change. Upon a Substantial Corporate Change, any portion of this Option that is unexercised will terminate unless provision is made in writing in connection with such transaction for:

- a. assumption or continuation of outstanding Options; or
- b. the substitution for such Options, with appropriate adjustments as to the number and kind of shares of stock and prices, in which event the Option will continue in the manner and under the terms so provided.

Unless the Board determines otherwise, if an Option would otherwise terminate pursuant to the preceding sentence, you will have the right, at such time before the consummation of the transaction causing such termination as the Board reasonably designates, to exercise any unexercised portions of the Option, whether or not previously exercisable.

A “*Substantial Corporate Change*” means the occurrence of any one or more of the following events:

- i. a Person (as the term person is used for purposes of Section 13(d) or 14(d) of the Securities Exchange Act of 1934, as amended) (other than the Company, any Company subsidiary, any Company benefit plan, or any underwriter temporarily holding securities for an offering of such securities) acquires ownership of 100% of the combined voting power of all classes of stock of the Company;
- ii. merger, consolidation or reorganization of the Company with or into one or more entities in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly owned subsidiary, a reincorporation of the Company in a different jurisdiction or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings);
- iii. merger, consolidation or reorganization of the Company in which the Company is the surviving corporation, but after which the stockholders of the Company immediately prior to such merger (other than any stockholder that merges, or which owns or controls another corporation that merges, with the Company in such merger) cease to own their shares or other equity interest in the Company;
- iv. the liquidation or dissolution of the Company; or
- v. the sale or disposition of all or substantially all of the Company's assets.

(5) Taxes.

- a. You understand and agree that the Company has not advised you regarding your income tax liability in connection with the Option. To the extent required by applicable federal, state, local or foreign law, you shall make arrangements satisfactory to the Company in its sole discretion for the satisfaction of any withholding tax obligations that arise by reason of an Option exercise or disposition of shares issued as a result of an Option exercise. The Company shall not be required to issue shares or to recognize the disposition of such shares until such obligations are satisfied.

- b. By accepting the Option, you agree that, unless and to the extent you have otherwise satisfied any U.S. federal income and other taxes, including state, local or non-U.S. income or employment tax obligations, related to the exercise of the Option that are required to be withheld and paid over to the applicable tax authorities (the “*Tax Withholding Obligations*”) in a manner permitted or required by the Administrator pursuant to the Plan, the Company is authorized (but not required) to deduct and retain without notice from the shares of Common Stock issuable to you in respect of the exercised portion of the Option the whole number of shares (rounding down) having a Fair Market Value on the exercise date or, if not a trading day, the first trading day before the exercise date (as determined by the Company consistent with any applicable tax requirements) sufficient to satisfy the applicable Tax Withholding Obligation. If the withheld shares are not sufficient to satisfy your Tax Withholding Obligation, you agree to pay to the Company as soon as practicable, by cash or check or, unless otherwise determined by the Administrator, deducted from salary or other amounts payable to you, any amount of the Tax Withholding Obligation that is not satisfied by the withholding of shares of Common Stock described above.
- c. You are ultimately liable and responsible for all taxes owed by you in connection with the Option, regardless of any action the Company takes or any transaction pursuant to this Section 5 with respect to any tax withholding obligations that arise in connection with the Option. The Company makes no representation or undertaking regarding the treatment of any tax withholding in connection with the grant, issuance, vesting or exercise of the Option or the subsequent sale of any of the shares of Common Stock acquired upon exercise of the Option. The Company does not commit and is under no obligation to structure the Option to reduce or eliminate your tax liability.

[NOTE: THE DIRECTOR FORM OF RESTRICTED STOCK GRANT WILL NOT HAVE THE PROVISIONS SET OUT IN THIS SECTION 5. INSTEAD, SECTION 5 IN THE DIRECTOR FORM WILL READ AS FOLLOWS: “All taxes, if any, in respect of the Option or any payments to you hereunder shall be solely your responsibility and shall be paid by you.”]

- (6) Company Postponement of Delivery. The Company may postpone issuing and delivering any Shares for so long as the Company determines to be necessary or advisable to satisfy the following:
- completing or amending any registration or qualification of the Shares or satisfying any exemption from registration under any federal or state law, rule, or regulation;
 - complying with any requests for representations under the Plan;

c. receiving proof satisfactory to the Company that a person seeking to exercise the Option after your death or disability is authorized and entitled to exercise the Option; and

d. satisfying any federal, state, or local tax withholding obligations.

(7) Compliance with Securities Laws.

a. If, at the time the Company should issue you Shares because of your exercise of the Option, no current registration statement under the Securities Act of 1933 (the "Act") covers such issuance, you must, before the Company will issue such Shares to you:

i. represent to the Company, in form satisfactory to the Company's counsel, that you are acquiring the Shares for your own account and not with a view to reselling or distributing the Shares; and

ii. agree that you may not sell, transfer, or otherwise dispose of the Shares issued to you under the Option unless:

A. a registration statement under the Act is effective at the time of disposition with respect to the Shares sold, transferred, or otherwise disposed of; or

B. the Company has received an opinion of counsel or other information and representations satisfactory to it to the effect that registration under the Act is not required by reason of Rule 144 under the Act or otherwise.

b. Notwithstanding anything herein to the contrary, you may not exercise the Option, and the Company shall not be obligated to deliver any shares of Common Stock, during any period when the Company determines that the exercisability of the Option or the delivery of shares hereunder would violate any applicable federal or state securities laws or other laws or regulations.

(8) Restrictions on Resales. The Company may impose such restrictions, conditions or limitations as it determines appropriate as to the timing and manner of any resales by you or other subsequent transfers by you of any shares of Common Stock issued as a result of the exercise of the Option, including without limitation (a) restrictions under an insider trading policy, (b) restrictions designed to delay and/or coordinate the timing and manner of sales by you and other optionholders and (c) restrictions as to the use of a specified brokerage firm for such resales or other transfers.

- (9) **Not an Employment Contract.** Nothing in this Agreement restricts the right of the Company or any of its affiliates to terminate your employment or other service at any time, with or without cause. The termination of employment or service, whether by the Company or any of its affiliates or otherwise, and regardless of the reason therefore, has the consequences provided for hereunder, under the Plan and under any applicable employment, severance or other agreement.
- (10) **Non-Transferability of Option.** You may not assign or transfer the Option to anyone other than by will or the laws of descent and distribution and the Option shall be exercisable only by you during your lifetime. The Company may cancel the Option if you attempt to assign or transfer it in a manner inconsistent with this Section 10.
- (11) **Limitation of Interest.** You understand and agree that you will not be deemed for any purpose to be a stockholder of the Company with respect to any of the Shares unless and until they have been issued to you after your exercise of this Option and payment for the Shares. Neither you (individually or as a member of a group) nor any beneficiary or other person claiming under or through you shall have any right, title, interest, or privilege in or to any shares of Common Stock allocated or reserved for the purpose of the Plan or subject to this Agreement except as to such shares of Common Stock, if any, as shall have been issued to such person upon exercise of the Option or any part of it.
- (12) **No Fractional Shares.** At the time of exercise, the Company will round down any fractional Shares but will not make any cash or other payments in settlement of fractional shares eliminated by rounding. If you have not then exercised the Option in full, the Company will carry forward the fractional Shares rather than eliminating them.
- (13) **No Limitation on Company Actions.** You understand and agree that the existence of this Option will not affect in any way the right or power of the Company or its stockholders to make or authorize any or all adjustments, recapitalizations, reorganizations, or other changes in the Company's capital structure or its business or any merger or consolidation of the Company, or any issuance of bonds, debentures, preferred or other stocks with preference ahead of or convertible into, or otherwise affecting the Common Stock or the rights thereof, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.

(14) General.

- a. This Agreement and the Plan constitute the entire understanding between you and the Company regarding the Option. Any prior agreements, commitments or negotiations concerning the Option are superseded.
- b. The laws of the State of Delaware will govern all matters relating to this Agreement, without regard to the principles of conflict of laws.
- c. Any notice you give to the Company (including notice of exercise of all or part of the Option) must be in writing and either hand-delivered or mailed to the Corporate Secretary of the Company (or to the Chief Financial Officer if either you would receive the notice or the position is vacant). If mailed, it should be sent by certified mail and be addressed to the foregoing executive at the Company's then corporate headquarters. Any notice given to you will be addressed to you at your address as reflected on the personnel records of the Company. You may change the address for notice by like notice to the Company. Notice will be deemed to have been duly delivered when hand-delivered, or, if mailed, two business days after such notice is postmarked.
- d. As a condition of this Option, you, on behalf of yourself, your heirs, successors and personal representatives ("*you and your successors*"), agree that any dispute or disagreement which may arise hereunder shall be decided by the Administrator. You and your successors agree to accept as binding, conclusive and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Option, and you and your successors hereby explicitly waive any right to judicial review.
- e. In the event that any provision of this Agreement is declared to be illegal, invalid or otherwise unenforceable by a court of competent jurisdiction, such provision shall be reformed, if possible, to the extent necessary to render it legal, valid and enforceable, or otherwise deleted, and the remainder of the terms hereunder shall not be affected except to the extent necessary to reform or delete such illegal, invalid or unenforceable provision.
- f. This Agreement shall inure to the benefit of and be binding upon the parties hereto and their respective permitted heirs, beneficiaries, successors and assigns.
- g. The headings preceding the text of the sections hereof are inserted solely for convenience of reference, and shall not constitute a part of this Agreement, nor shall they affect its meaning, construction or effect.

- h. All questions arising under the Plan or under this Agreement shall be decided by the Administrator in its total and absolute discretion.
- i. Wherever a conflict may arise between the terms of this Agreement and the terms of the Plan, the terms of the Plan will control.

C **OSTAR GROUP, INC.**
By: _____
Name: _____
Title: _____

ACKNOWLEDGMENT

I acknowledge receipt of a copy of the attached Plan. I represent that I have read and am familiar with the Plan's terms. I accept the Option subject to all of the terms and provisions of this Agreement and of the Plan under which it is granted, as the Plan may be amended in accordance with its terms. I agree to accept as binding, conclusive, and final all decisions or interpretations of the Administrator concerning any questions arising under the Plan with respect to the Option.

Date:

Signature of Grantee/Participant

No one may sell, transfer, or distribute this Option or the securities that may be purchased upon exercise of this Option without an effective registration statement relating thereto or an opinion of counsel satisfactory to the Company or other information and representations satisfactory to the Company that such registration is not required.

Item 1. Business

(In this report, the words “we,” “our,” “us,” “CoStar” or the “Company” refer to CoStar Group, Inc. and its direct and indirect subsidiaries. This report also refers to our web sites, but information contained on those sites is not part of this report.)

CoStar Group, Inc., a Delaware corporation, is the leading provider of information services to the commercial real estate industry in the United States and United Kingdom 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 services than any of our competitors and believe we generate more revenues than any of our competitors. CoStar’s integrated suite of services offers customers online access to the most comprehensive database of commercial real estate information, which has been researched and verified by our team of researchers, currently covering 66 U.S. markets as well as London and other parts of the United Kingdom (“U.K.”) and France. CoStar has historically operated within one business segment. Due to the increased size, complexity, and funding requirements associated with the Company’s international expansion in 2007, the Company began to manage the business geographically in two operating segments, with the primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France.

Since its founding in 1987, CoStar’s strategy has been to provide commercial real estate professionals with critical knowledge to explore and complete transactions, by offering the most comprehensive, timely and standardized information on U.S. commercial real estate. As a result of our January 2003 acquisition of Focus Information Limited, June 2004 acquisition of Scottish Property Network, December 2006 acquisition of Grecam S.A.S., and February 2007 acquisition of Property Investment Exchange Limited, we have extended our offering of comprehensive commercial real estate information to include London and other parts of The United Kingdom and France. Information about CoStar’s revenues from, and long-lived assets located in, foreign countries is included in Note 2 to the notes to our consolidated financial statements. Information about risks attendant to our foreign operations is included in “Item 7A. Quantitative and Qualitative Disclosures about Market Risk.”

We deliver our content to customers via an integrated suite of online service offerings that includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, property information for clients’ web sites, information about industry professionals and their business relationships, analytic information, data integration, property marketing and industry news. We have created and are continuing to improve a standardized information platform where the commercial real estate industry and related businesses can continuously interact and easily facilitate transactions due to the efficient exchange of accurate information supplied by CoStar.

We have a number of assets that provide a unique foundation for our multinational platform, including the most comprehensive proprietary database in the industry; the largest research department in the industry; proprietary data collection, information management and quality control systems; a large in-house product development team; a broad suite of web-based information services; and a large base of clients. Our database has been developed and enhanced for more than 19 years by a research department that makes thousands of daily database updates. In addition to our internal efforts to grow the database, we have obtained and assimilated over 51 proprietary databases.

CoStar intends to continue to grow its standardized platform of commercial real estate information. In 2004, CoStar began research for a 21-market U.S. expansion effort. As of February 21, 2006, CoStar had successfully launched service in each of those 21 markets. In addition, following our acquisition of National Research Bureau in January 2005, we launched various research initiatives as part of our expansion into real estate information for retail properties. In July 2006, we announced our intention to commence actively researching commercial properties in approximately 100 new Metropolitan Statistical Areas (“MSAs”) across the United States in an effort to expand the geographical coverage of our service offerings, including our new retail service. CoStar intends to continue to grow its database of commercial properties, including retail, over the next several years.

CoStar also intends to invest further in its U.K. operations and to expand the coverage of its service offerings within the U.K. and France. In December 2006, CoStar's U.K. Subsidiary, CoStar Limited, acquired Grecam S.A.S., 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, a provider of commercial property information and operator of an investment property exchange located in London, England. CoStar intends to integrate its U.K. and French operations more fully with its U.S. operations and eventually to introduce a consistent international platform of service offerings.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate approximately 96% of our total revenues. 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 increase in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus 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.

Industry Overview

The market for commercial real estate information is vast based on the variety, volume and value of transactions related to commercial real estate. Each transaction has multiple participants and multiple information requirements, and in order to facilitate transactions, industry participants must have extensive, accurate and current information. Members of the commercial real estate and related business community require daily access to current data such as space availability, rental rates, vacancy rates, tenant movements, sales comparables, supply, new construction, absorption rates and other important market developments to carry out their businesses effectively. There is a strong need for an efficient marketplace, where commercial real estate professionals can exchange information, evaluate opportunities using standardized data and interact with each other on a continuous basis.

A large number of parties involved in the commercial real estate and related business community make use of the services we provide in order to obtain information they need to conduct their businesses, including:

- | | |
|--|--|
| <ul style="list-style-type: none">• Sales and leasing brokers• Property owners• Property managers• Design and construction professionals• Real estate developers• Real estate investment trust managers• Investment bankers• Commercial bankers• Mortgage bankers• Mortgage brokers• Retailers | <ul style="list-style-type: none">• Government agencies' staff members• Mortgage-backed security issuers• Appraisers• Pension fund managers• Reporters• Tenant vendors• Building services vendors• Communications providers• Insurance companies' managers• Institutional advisors• Investors and asset managers |
|--|--|

The commercial real estate and related business community generally has operated in an inefficient marketplace because of the fragmented approach to gathering and exchanging information within the marketplace. Various organizations, including hundreds of brokerage firms, directory publishers and local research companies, collect data on specific markets and develop software to analyze the information they have independently gathered. This highly fragmented methodology has resulted in duplication of effort in the collection and analysis of information, excessive internal cost and the creation of non-standardized data containing varying degrees of accuracy and comprehensiveness, resulting in a formidable information gap.

The creation of a standardized information platform for commercial real estate requires an infrastructure including a standardized database, accurate and comprehensive research capabilities, easy to use technology and intensive participant interaction. By combining its extensive database, approximately 849 researchers, technological expertise and broad customer base, CoStar believes that it has created such a platform.

CoStar’s Comprehensive Database

CoStar has spent more than 19 years building and acquiring a database of commercial real estate information, which includes information on leasing, sales, comparable sales, tenants, and demand statistics, as well as digital images.

As of January 31, 2007, our database of real estate information covered 66 U.S markets as well as London, England and other parts of the United Kingdom and France, and contained:

- More than 37.5 billion square feet of U.S. commercial real estate;
- More than 650,000 active sale and lease listings in our U.S. database;
- Over 1.2 million extensively researched and photographed properties in our U.S. database;
- Over 2.1 million total properties;
- Over 5.8 billion square feet of space available;
- Over 235,000 properties for sale;
- Over 3.9 million tenants occupying commercial real estate space;
- More than 1.6 million sales transactions valued in the aggregate at over \$2.2 trillion; and
- Approximately 3.9 million digital images, including building photographs, aerial photographs, plat maps and floor plans.

This highly complex database is comprised of hundreds of data fields, tracking such categories as:

- | | |
|---|---|
| <ul style="list-style-type: none">• Location | <ul style="list-style-type: none">• Mortgage and deed information |
| <ul style="list-style-type: none">• Site and zoning information | <ul style="list-style-type: none">• For-sale information |
| <ul style="list-style-type: none">• Building characteristics | <ul style="list-style-type: none">• Income and expense histories |
| <ul style="list-style-type: none">• Space availability | <ul style="list-style-type: none">• Tenant names |
| <ul style="list-style-type: none">• Tax assessments | <ul style="list-style-type: none">• Lease expirations |
| <ul style="list-style-type: none">• Ownership | <ul style="list-style-type: none">• Contact information |
| <ul style="list-style-type: none">• Sales and lease comparables | <ul style="list-style-type: none">• Historical trends |
| <ul style="list-style-type: none">• Space requirements | <ul style="list-style-type: none">• Demographic information |
| <ul style="list-style-type: none">• Number of retail stores | <ul style="list-style-type: none">• Retail sales per square foot |

CoStar Research

We have developed a sophisticated data collection organization utilizing a multi-faceted research process. In 2006, our full time researchers and contractors drove over three million miles, conducted hundreds of thousands of on-site building inspections, and interviewed millions of tenants, owners and brokers.

Research Department. As of January 31, 2007, we employed 849 commercial real estate research professionals. Our research professionals undergo an extensive training program so that we can maintain consistent research methods and processes throughout our research department. Our researchers collect and analyze commercial real estate information through millions of phone calls, e-mails, Internet updates and faxes each year, in addition to field inspections, public records review, news monitoring and direct mail. Each researcher is responsible for maintaining the accuracy and reliability of the database. As part of their update process, researchers develop cooperative relationships with industry professionals that allow them to gather useful information. Because of the importance commercial real estate professionals place on our data and our prominent position in the industry, many of these professionals routinely take the initiative and proactively report available space and transactions to our researchers. In 2006, we began outsourcing a limited number of research related projects to outside firms to supplement the work of our research employees.

CoStar has an extensive field research effort that permits physical inspection of properties in order to research new markets, find additional inventory, photograph properties and verify existing information. CoStar's research efforts have traditionally focused on office and industrial properties. Following our acquisition of National Research Bureau in January 2005, we launched a major expansion effort into real estate information for retail properties. In July 2006, we announced our intention to commence actively researching commercial properties in approximately 100 new MSAs across the United States in an effort to expand the geographical coverage of our service offerings, including our new retail service.

As part of CoStar's recent expansion efforts, CoStar has deployed 155 high-tech field research vehicles in 43 states and the United Kingdom. 103 of these vehicles are custom-designed energy efficient hybrid cars that come equipped with computers, proprietary Global Positioning System tracking software, high resolution digital cameras and handheld laser instruments to help precisely measure buildings, geo-code them and position them on digital maps. Some of our researchers also use custom-designed trucks with the same equipment as well as pneumatic masts that extend up to an elevation of twenty-five feet to allow for unobstructed building photographs from "birds-eye" views. Each CoStar vehicle uses wireless technology to track and transmit field data. A typical site inspection consists of photographing the building, measuring the building, geo-coding the building, capturing "For Lease" sign information, counting parking spaces, assessing property condition and construction, and gathering tenant information. Certain researchers canvass properties, interviewing tenants suite by suite. In addition, many of our field researchers are photographers who take photographs of commercial real estate properties to add to CoStar's database of digital images. Since we began our 21-market expansion in May 2004, and continuing with our current expansion into an additional 100 MSAs, our field researchers have photographed approximately 409,000 buildings and researched over 8.2 billion square feet of gross building area in the expansion markets.

Data and Image Providers. We license a small portion of our data and images from public record providers and third-party data sources. Licensing agreements with these entities provide for our use of a variety of commercial real estate information, including property ownership, tenant information, maps and aerial photographs, all of which enhance various CoStar services. These license agreements generally grant us a non-exclusive license to use the data and images in the creation and supplementation of our information services and include what we believe are standard terms, such as a contract term ranging from two to five years, automatic renewal of the contract and fixed periodic license fees or a combination of fixed periodic license fees plus additional fees based upon our usage.

Management and Quality Control Systems. Our research processes include automated and non-automated controls to ensure the integrity of the data collection process. A large number of automated data quality tests check for potential errors, including occupancy date conflicts, available square footage greater than building area, typical floor space greater than land area and expired leases. We also monitor changes to critical fields of information to ensure all information is kept in compliance with our standard definitions and methodology. Our non-automated quality control procedures include:

- calling our information sources on recently-updated properties to re-verify information;
- performing periodic research audits and field checks to determine if we correctly canvassed all buildings;
- providing training and retraining to our research professionals to ensure accurate data compilation; and
- compiling measurable performance metrics for research teams and managers for feedback on data quality.

Finally, one of the most important and effective quality control measures we rely on is feedback provided by the commercial real estate professionals using our data every day.

Proprietary Technology

As of January 31, 2007, CoStar had a staff of 98 product development, database and network professionals. CoStar’s information technology professionals focus on developing new services for our customers and delivering research automation tools that improve the quality of our data and increase the efficiency of our research analysts.

Our information technology team is responsible for developing and maintaining CoStar products including CoStar Property Professional, CoStar Property Express, CoStar COMPS, CoStar Tenant, CoStar CMLS and CoStar Connect. To better support our retail customers we have recently added significant features to CoStar Property including tenant proximity and demographic search capability, mapping layers, detailed retail tenant information and demographics. CoStar also released a major upgrade to its CoStar COMPS service that provides customers with over 100 improvements, including access to for sale information, aerials and enhanced mapping.

Our information technology team is responsible for developing the infrastructure necessary to support CoStar’s business processes, our comprehensive database of commercial real estate information and our extensive image library. The team implements technologies and systems that introduce efficient workflows and controls that increase the production capacity of our research teams and improve the quality of our data. Over the years, the team has developed data collection and quality control mechanisms that we believe are unique to the commercial real estate industry. The team continues to develop and modify our enterprise information management system that integrates CoStar sales, research, field research, customer support and accounting information. We use this system to maintain our commercial real estate research information, manage contacts with the commercial real estate community, provide research workflow automation and conduct daily automated quality assurance checks.

Our information technology professionals also maintain the servers and network components necessary to support CoStar services and research systems. Our encrypted virtual private network provides remote researchers and salespeople secure access to CoStar applications and network resources. CoStar maintains a comprehensive data protection policy that provides for use of encrypted data fields and off-site storage of all system backups, among other protective measures. CoStar’s services are continually monitored in an effort to ensure our customers fast and reliable access.

Services

Our suite of information services is branded and marketed to our customers. Our services are derived from a database of building-specific information and offer customers specialized tools for accessing, analyzing and using our information. Over time, we expect to enhance our existing information services and develop additional services that make use of our comprehensive database to meet the needs of our existing customers as well as potential new categories of customers.

Our various information services are described in detail in the following paragraphs as of January 31, 2007:

CoStar Property Professional®. CoStar Property Professional, or “CoStar Property,” is the Company’s flagship service. It provides subscribers a comprehensive inventory of office, industrial and retail properties in markets throughout the United States, including for-lease and for-sale listings, historical data, building photographs, maps and floor plans. Commercial real estate professionals use CoStar Property to identify available space for lease, evaluate leasing and sale opportunities, value assets and position properties in the marketplace. Our clients also use CoStar Property to analyze market conditions by calculating current vacancy rates, absorption rates or average rental rates, and forecasting future trends based on user-selected variables. CoStar Property provides subscribers with powerful map-based search capabilities as well as a user-controlled, password-protected extranet (or electronic “file cabinet”) where brokers may share space surveys and transaction-related documents online in real time with team members. When used together with CoStar Connect, CoStar Property enables subscribers to share space surveys and transaction-related documents with their clients, accessed through their corporate web site. CoStar Property, along with all of CoStar’s other core information services, are delivered solely via the Internet.

CoStar Property Express[®]. CoStar Property Express provides access, via an annual subscription, to a “light” or scaled-down version of CoStar Property. Commercial real estate professionals use CoStar Property Express to look up and search for-lease and for-sale listings in CoStar’s comprehensive national database. CoStar Property Express provides base-building information, photos, floor plans, maps and a limited number of reports.

CoStar COMPS Professional[®]. CoStar COMPS Professional provides comprehensive national coverage of comparable sales information in the U.S. commercial real estate industry. It is the industry’s most comprehensive database of comparable sales transactions and is designed for professionals who need to research property comparables, identify market trends, expedite the appraisal process and support property valuations. In November 2006, we launched a major upgrade to the COMPS Professional service, which now offers subscribers many new features, including additional fields of property information, access to support documents (e.g., deeds of trust) for new comparables, demographics and the ability to view for-sale properties alongside sold properties in three formats – plotted on a map, aerial image or in a table.

CoStar COMPS Express[®]. CoStar COMPS Express provides users with immediate, subscription-free access with a credit card to the CoStar COMPS Professional system on a report-by-report basis. Subscribers also use this on-demand service to research comparable sales information outside of their subscription markets.

CoStar Tenant[®]. CoStar Tenant is a detailed online business-to-business prospecting and analytical tool providing commercial real estate professionals with the most comprehensive real estate-related U.S. tenant information available. CoStar Tenant profiles tenants occupying space in commercial buildings across the United States and provides updates on lease expirations -- one of the service’s key features -- as well as occupancy levels, growth rates and numerous other facts. Delivering this information via the Internet allows users to target prospective clients quickly through a searchable database that identifies only those tenants meeting certain criteria. CoStar Tenant subscribers can also obtain credit reports through CoStar Tenant directly from D&B[®].

FOCUS. Our U.K. subsidiary, FOCUS Information Limited, offers several services under the trade name FOCUS. The primary service is a digital online service offering information on the U.K. commercial real estate market. This service seamlessly links data on individual properties and companies including comparable sales, available space, requirements, tenants, lease deals, planning information, socio-economics and demographics, credit ratings, photos and maps across the United Kingdom. In addition, FOCUS Information’s subsidiary, Scottish Property Network Limited, offers users on-line access to a comprehensive database of information for properties located in Scotland, including available space, comparable sales, and lease deals.

CoStar Connect[®]. CoStar Connect allows commercial real estate firms to license CoStar’s technology and information to market their U.S. property listings on their corporate web sites. Customers enhance the quality and depth of their listing information through access to CoStar’s database of content and digital images. The service automatically updates and manages customers’ online property information, providing comprehensive listings coverage and significantly reducing the expense of building their web sites’ content and functionality.

CoStar Commercial MLS[®]. CoStar Commercial MLS is the industry’s most comprehensive collection of researched for-sale listings. CoStar Commercial MLS draws upon CoStar’s large database of digital images and includes office, industrial, multi-family and retail properties, as well as shopping centers and raw land. CoStar Commercial MLS represents an efficient means for sellers to market their properties to a large audience and for buyers to easily identify target properties.

CoStar Advertising[®]. CoStar Advertising offers property owners a highly targeted and cost-effective way to market a space for lease or a property for sale directly to the individuals looking for that type of space through interactive advertising. Our advertising model is based on varying levels of exposure, enabling the advertiser to target as narrowly or broadly as its budget permits. With the CoStar Advertising program, when the advertiser's listings appear in a results set, they receive priority positioning and are enhanced to stand out. The advertiser can also purchase exposure in additional submarkets, or the entire market area so that his ad will appear even when his listing would not be returned in a results set.

CoStar Professional Directory[®]. CoStar Professional Directory, a service available exclusively to CoStar Property Professional subscribers, provides detailed contact information for approximately 750,000 commercial real estate professionals, including specific information about an individual's current and prior activities such as completed transactions, current landlord representation assignments, sublet listings, major tenants and owners represented and local and national affiliations. Commercial real estate brokers can input their biographical information and credentials and upload their photo to create personal profiles. Subscribers use CoStar Professional Directory to network with their peers, identify and evaluate potential business partners, and maintain accurate mailing lists of other industry professionals for their direct mail marketing efforts.

CoStar Market Report[™]. The CoStar Market Report provides in-depth current and historical analytical information covering 54 of the major metropolitan office and industrial markets in the United States and 13 retail markets in the United States. Published quarterly, each market report includes details such as absorption rates, vacancy rates, rental rates, average sales prices, capitalization rates, existing inventory and current construction activity. This data is presented using standard definitions and calculations developed by CoStar, and offers real estate professionals critical and unbiased information necessary to make intelligent commercial real estate decisions. CoStar Market Reports are available to CoStar Property Professional subscribers at no additional charge, and are available for purchase by nonsubscribers.

Metropolis[™]. The Metropolis service is a single interface that combines commercial real estate data from multiple information providers into a comprehensive resource. The Metropolis service allows a user to input a property address and then view detailed information on that property from multiple information providers, including CoStar services. This technology offers commercial real estate professionals a simple and convenient solution for integrating a wealth of third-party information and proprietary data, and is currently available for the Southern California markets.

Clients

We draw clients from across the commercial real estate and related business community. Commercial real estate brokers have traditionally formed the largest portion of CoStar clients, however, we also provide services to owners, landlords, financial institutions, retailers, vendors, appraisers, investment banks and other parties involved in commercial real estate. The following chart lists U.S. and U.K. clients that are well known or have the highest annual subscription fees in each of the various categories, each as of January 31, 2007.

Brokers	Lenders, Investment Bankers	Institutional Advisors, Asset Managers
CB Richard Ellis CB Richard Ellis — U.K. Colliers Colliers Conrad Ritblat Erdman — U.K. Cushman & Wakefield Cushman & Wakefield Healey & Baker — U.K. Trammell Crow Co. Jones Lang LaSalle Jones Lang LaSalle — U.K. Grubb&Ellis Gerald Eve — U.K. Drivers Jonas — U.K. Lambert Smith Hampton — U.K. BRE Commercial, LLC Marcus & Millichap The Staubach Company Newmark & Company Real Estate CRESA Partners Studley Coldwell Banker Commercial NRT Equis GVA Williams GVA Advantis Binswanger Re/Max Carter United Systems Integrators Corp GVA Daum Finkelstein Comm Rlty Services KTR Valuation & Consulting Services U.S. Equities Realty CMD Realty Investors Sperry Van Ness HFF Mohr Partners Charles Dunn Company, Inc. GVA Grimley — U.K. King Sturge — U.K. Knight Frank — U.K. Donaldsons — U.K. Savillis Commercial — U.K. Artisreal — U.K.	GMAC — U.K. Deutsche Bank Wells Fargo Washington Mutual Wachovia Corporation Merrill Lynch Citibank AEGON USA Realty Advisors, Inc. Capmark Financial Group, Inc. East West Bank Bonneville Mortgage Company Fannie Mae	Jones Lang LaSalle Prudential Prudential — U.K. Metropolitan Life ING Clarion Partners Bear Stearns & Co., Inc. USAA Real Estate Company Legg Mason Morley — U.K. AEW Capital Management LP.
	Owners and Developers	Appraisers, Accountants
	Hines LNR Property Corp Shoreinstein Properties Gale Companies Manulife Financial Industrial Developments International Land Securities — U.K. Slough Estates — U.K.	Integra Deloitte and Touche Deloitte and Touche — U.K. Marvin F. Poer KPMG GE Capital Small Business Finance Corp PGP Valuation PricewaterhouseCoopers
	REITS	Government Agencies
	Equity Office Properties Trust Trizec Properties, Inc. Prologis Prentiss Properties CarrAmerica Boston Properties Liberty Property Trust	U.S. General Services Administration County of Los Angeles Office of Technology Procurement City of Chicago Cook County Assessor's Office U.S. Department of Housing and Urban Development Corporation of London — U.K. Scottish Enterprise – U.K.
	Property Managers	Vendors
	Transwestern Commercial Services Lincoln Property Company PM Realty Group Navisys Group Osprey Management Company Leggat McCall Properties	Turner Construction Company Kastle Systems Comcast Cable Communications Cisco Systems MWB — U.K. Regus — U.K.
	Retailers	
DSW Quiznos Master LLC Family Dollar Chick-Fil-A, Inc. Dippin' Dots Franchising, Inc.	Automobile Club Of Southern California Hibbett Sporting Goods Inc. Nationwide Insurance Pathmark	Town Fair Tire Whataburger, Inc. United Rentals, Inc. Tiffany & Co.

For the years ended December 31, 2004, 2005 and 2006, no single client accounted for more than 5% of our revenues.

Sales and Marketing

As of January 31, 2007, we had 253 sales, marketing and customer support employees, with the majority of our direct sales force located in field sales offices. Our sales teams are primarily located in 25 field sales offices throughout the United States and in London, England; Manchester, England; Paisley, Scotland and Paris, France. Our two inside sales teams are located in our Columbia, Maryland and Bethesda, Maryland offices. These inside sales teams prospect for new clients and perform service demonstrations exclusively by telephone and over the Internet and support the direct sales force.

Our local offices typically serve as the platform for our in-market sales, customer support and field research operations for their respective regions. The sales force is responsible for selling to new prospects, training new and existing clients, providing ongoing customer support, renewing existing client contracts and identifying cross-selling opportunities. In addition, the sales force has primary front-line responsibility for customer care.

Our sales strategy is to aggressively attract new clients, while providing ongoing incentives for existing clients to subscribe to additional services. We place a premium on training new and existing client personnel on the use of our services so as to promote maximum client utilization and satisfaction with our services. Our strategy also involves entering into multi-year, multi-market license agreements with our larger clients.

We seek to make our services essential to our clients' businesses. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus 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. In addition, through CoStar Property Express and CoStar COMPS Express, clients can access our database of commercial real estate information without a subscription.

Our customer service and support staff is charged with ensuring high client satisfaction by providing ongoing customer support.

Our primary marketing methods include: service demonstrations; face to face networking; Web-based marketing; direct marketing; communication via our corporate web site and news services; participation in trade show and industry events; print advertising in trade magazines and local business journals; client referrals; and CoStar Advisor™, the Company's newsletter, which is distributed to our clients and prospects. Web-based marketing and direct marketing are the most cost-effective means for us to find prospective clients. Our Web-based marketing efforts include paid advertising with major search engines and commercial real estate news sites and our direct marketing efforts include direct mail, email and telemarketing, and make extensive use of our unique, proprietary database. Once we have identified a prospective client, our most effective sales method is a service demonstration. We use various forms of advertising to build brand identity and reinforce the value and benefits of our services. We also sponsor and attend local association activities and events, and attend and/or exhibit at industry trade shows and conferences to reinforce our relationships with our core user groups, including industry-leading events for commercial brokers, retail and financial services institutions.

Competition

The market for information services generally is competitive and rapidly changing. In the commercial real estate industry, the principal competitive factors for commercial real estate information services and providers are:

- quality and depth of the underlying databases;
- ease of use, flexibility, and functionality of the software;
- timeliness of the data;
- breadth of geographic coverage and services offered;
- client service and support;
- perception that the service offered is the industry standard;
- price;
- effectiveness of marketing and sales efforts;
- proprietary nature of methodologies, databases and technical resources;
- vendor reputation;
- brand loyalty among customers; and
- capital resources.

We compete directly and indirectly for customers with the following categories of companies:

- online services or web sites targeted to commercial real estate brokers, buyers and sellers of commercial real estate properties, insurance companies, mortgage brokers and lenders, such as LoopNet, Inc., Reed Business Information Limited, Cityfeet.com, Inc., officespace.com, MrOfficeSpace.com and TenantWise, Inc;
- publishers and distributors of information services, including regional providers and national print publications, such as Black's Guide, Marshall & Swift, Yale Robbins, Inc., Reis, Inc., Real Capital Analytics and Dorey Publishing and Information Services;
- locally controlled real estate boards, exchanges or associations sponsoring property listing services and the companies with whom they partner, such as Xceligent, the Commercial Association of Realtors Data Services and the Association of Industrial Realtors;
- in-house research departments operated by commercial real estate brokers; and
- public record providers.

As the commercial real estate information marketplace develops, additional competitors (including companies which could have greater access to data, financial, product development, technical or marketing resources than we do) may enter the market and competition may intensify. While we believe that we have successfully differentiated ourselves from existing competitors, competition could materially harm our business.

Proprietary Rights

To protect our proprietary rights in our methodologies, database, software, trademarks and other intellectual property, we depend upon a combination of:

- trade secret, copyright, trademark, database protection and other laws;
- nondisclosure, noncompetition and other contractual provisions with employees and consultants;
- license agreements with customers;
- patent protection; and
- technical measures.

We seek to protect our software's source code, our database and our photography as trade secrets and under copyright law. Although copyright registration is not a prerequisite for copyright protection, we have filed for copyright registration for many of our databases, photographs, software and other materials. Under current U.S. law, the arrangement and selection of data may be protected, but the actual data itself may not be. In addition, with respect to our U.K. databases, certain database protection laws provide additional protections of these databases. We license our services under license agreements that grant our clients non-exclusive, non-transferable licenses. These agreements restrict the disclosure and use of our information and prohibit the unauthorized reproduction or transfer of the information services we license.

We also attempt to protect the secrecy of our proprietary database, our trade secrets and our proprietary information through confidentiality and noncompetition agreements with our employees and consultants. Our services also include technical measures designed to discourage and detect unauthorized copying of our intellectual property.

We have filed trademark applications to register trademarks for a variety of names for CoStar services and other marks, and have obtained registered trademarks for a variety of our marks, including “CoStar”, “COMPS”, “CoStar Property”, “CoStar Tenant” and “CoStar Group”. Depending upon the jurisdiction, trademarks are generally valid as long as they are in use and/or their registrations are properly maintained and they have not been found to become generic. We consider our trademarks in the aggregate to constitute a valuable asset. In addition, we have filed several patent applications covering certain of our methodologies and software and currently have one patent in the U.K. which expires in 2021 covering, among other things, certain of our field research methodologies, and three patents in the U.S. which expire in 2020, 2021 and 2022, respectively, covering, among other things, critical elements of CoStar’s proprietary field research technology and mapping tools. We regard the rights under our patents as valuable to our business but do not believe that our business is materially dependent on any single patent.

Employees

As of January 31, 2007, we employed 1,308 employees. None of our employees is represented by a labor union. We have experienced no work stoppages. We believe that our employee relations are excellent.

Available Information

Our investor relations Internet web site is <http://www.costar.com/corporate/investor>. The reports we file with or furnish to the Securities and Exchange Commission, including our annual report, quarterly reports and current reports, are available free of charge on our Internet web site as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. You may review and copy any of the information we file with the Securities and Exchange Commission at the Commission's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You may obtain information regarding the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The Securities and Exchange Commission maintains an internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the Commission at <http://www.sec.gov>.

Item 7. 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. There are many risks and uncertainties that could cause actual results to differ materially from those discussed in the forward-looking statements. Potential factors that could cause actual results to differ materially from those discussed in any forward-looking statements include, but are not limited to, those stated above in Item 1A. under the headings “Risk Factors ¾ Cautionary Statement Concerning Forward-Looking Statements” and “¾Risk Factors,” as well as those described from time to time in our filings with the Securities and Exchange Commission.

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 Reports 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 consolidated financial statements and related notes in this Annual Report on Form 10-K.

Overview

CoStar is the leading provider of information services to the commercial real estate industry in the United States and the United Kingdom 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 services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information platform where the 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, information for clients’ web sites, information about industry professionals and their business relationships, analytic information, data integration, property marketing and industry news. Our service offerings span all commercial property types - office, industrial, retail, land, mixed-use, hospitality and multifamily.

Since 1994, we have expanded the geographical coverage of our existing information services and developed new information services. In addition to internal growth, 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, a San Diego-based provider of commercial real estate information. In November 2000, we acquired First Image Technologies, Inc. In September 2002, we expanded further into Portland, Oregon through the acquisition of certain assets of Napier Realty Advisors d/b/a REAL-NET. In January 2003, we established a base in the United Kingdom with our acquisition of London-based Property Intelligence. 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 United Kingdom through the acquisition of Scottish Property Network. In September 2004, we strengthened our position in Denver, Colorado through the acquisition of substantially all of the assets of RealComp, Inc., a local comparable sales information provider. In January 2005, we acquired National Research Bureau (“NRB”), a leading provider of U.S. shopping center information. Additionally, in December 2006, our U.K. Subsidiary, Costar Limited, acquired Grecam S.A.S. (“Grecam”) located in Paris, France, a provider of commercial property information and market-level surveys, studies and consulting services. In February 2007, CoStar Limited also acquired Property Investment Exchange Limited (“Propex”), a provider of commercial property information and operator of an investment property exchange located in London, England. The more recent acquisitions are discussed later in this section.

Our current expansion plan began in 2004 and included entering 21 new metropolitan markets throughout the United States as well as expanding the geographical boundaries of many of our existing U.S. and U.K. markets during 2005 and 2006. As of February 2006, our expansion into the 21 new markets was complete.

In early 2005 we announced the launch of a major effort to expand our coverage of retail real estate information. The new 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 July 2006, we announced our intention to commence actively researching commercial properties in approximately 100 new Metropolitan Statistical Areas ("MSAs") across the United States in an effort to expand the geographical coverage of our service offerings, including our new retail service. During 2006, in connection with our plan to actively research commercial properties in these new MSAs, we increased our U.S. field research fleet by adding 89 vehicles and hired researchers to staff these vehicles. Further, in support of our expanded research efforts, we opened a research facility under a short-term lease in White Marsh, Maryland and hired and trained additional researchers and other personnel. We intend to enter into a long-term lease for a new research facility in White Marsh, Maryland in 2007.

As a result of our recent acquisitions of Propex and Grecam, we also intend to invest further in our U.K. and French operations and to expand the coverage of our service offerings within the U.K. and France. CoStar intends to integrate its U.K. and French operations more fully with those of the U.S. and eventually to introduce a consistent international platform of service offerings.

Our current expansion plan, further geographical expansion into approximately 100 new MSAs, expansion of coverage of retail real estate information, expansion of our coverage in existing markets and expansion of our U.K. and French operations, has caused, and will continue to cause, our cost structure to escalate in advance of the revenues that we expect to generate from these new markets and services, which may reduce our earnings or earnings growth.

We expect to continue to develop and distribute new services, expand existing services and coverage across our current markets, expand geographically in the U.S. and international markets, consider strategic acquisitions, and expand our sales and marketing organization. Any future significant expansion could reduce our profitability and significantly increase our capital expenditures. Therefore, while we expect current service offerings in existing markets to remain generally profitable and provide substantial funding for our overall business, it is possible that further overall expansion could cause us to generate losses and negative cash flow from operations in the future.

We expect 2007 revenue to grow over 2006 revenue as a result of further penetration of our services in our potential customer base across our platform, successful cross selling of our services to our existing customer base, continued geographic expansion and acquisitions. We expect that 2007 EBITDA, which is our net-income before interest, income taxes, depreciation and amortization, could increase from 2006 based on the growth in EBITDA from U.S. operations, which will be partially offset by our plan to expand and integrate our U.K. and French operations. We anticipate our EBITDA for our existing core platform to continue to grow principally due to growth in revenue.

Beginning on January 1, 2006, we began accounting for stock based compensation under the provisions of SFAS No. 123R, "Share-Based Payment" ("SFAS 123R"), which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. Upon adoption of SFAS 123R in the first quarter of 2006, we recorded a charge in general and administrative expenses in our consolidated statements of operations of approximately \$35,000, representing the cumulative effect of a change in accounting principle.

In 2006, we issued restricted stock and stock options to our officers, directors and employees, and as a result we recorded additional compensation expense in our consolidated statement of operations. We plan to continue the use of alternative 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 consolidated statement of operations and reduce our net income. We incurred approximately \$4.2 million in total equity compensation expense in 2006.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate approximately 96% of our total revenues. 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 increase in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus 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.

For the years ended December 31, 2005 and 2006, our contract renewal rate was over 90%.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States 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.

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. Factors we consider important that could trigger an impairment review include the following:

- 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 measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

Goodwill and identifiable intangible assets not subject to amortization are tested annually on October 1st of each year for impairment and may be tested for impairment more frequently based upon the existence of one or more of the above indicators. We measure any impairment loss as the extent to which the carrying amount of the asset exceeds its fair value.

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 sheet. 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 statement of operations.

As of the fourth quarter of 2004, we determined that it was more likely than not that we would generate taxable income from operations and be able to realize tax benefits arising from use of our net operating loss carryforwards to reduce the income tax we will owe on this taxable income. Prior to the fourth quarter of 2004, we recorded a valuation allowance on the deferred tax assets associated with these future tax benefits because we were not certain we would generate taxable income in the future. The release of the valuation allowance in the fourth quarter of 2004 resulted in a tax benefit of approximately \$26.2 million. This included an income tax benefit of approximately \$16.7 million that was recognized in our results from operations. We also recognized a tax benefit of approximately \$9.5 million as additional paid-in capital for our net operating loss carryforwards attributable to tax deductions for stock options. As of December 31, 2006, we continued to maintain a valuation allowance of approximately \$337,000 for certain state net operating loss carryforwards. At December 31, 2006, we had net operating loss carryforwards for federal income tax purposes of approximately \$43.1 million, which expire, if unused, from the year 2013 through the year 2023.

Our decision to release the valuation allowance on our deferred tax asset was based on our expectation that we will recognize taxable income from operations in the future, which will enable us to use our net operating loss carryforwards. We believe our expectation that we will recognize taxable income in the future is supported by our increase in net earnings over the last three years, our revenue growth, our renewal rates with our existing customers, and our business model, which permits some control over future costs. We will continue to evaluate our expectation of future taxable income during each quarter. If we are unable to conclude that it is more likely than not that we will realize the future tax benefits associated with our deferred tax assets, then we may be required to establish a valuation allowance against some or all of the deferred tax assets.

For the next two years, however, we expect the majority of our taxable income to be offset by our net operating loss carryforwards. As a result, we expect our cash payments for taxes to be limited primarily to federal alternative minimum taxes and to state income taxes in certain states. Our U.K. expansion will generate net operating losses in the U.K. The loss in the U.K. will generate a lower tax benefit than if the costs were incurred in the U.S., thereby creating a higher effective tax rate in 2007.

Effective for fiscal quarters beginning after December 31, 2006, we will adopt the provisions of FIN 48 "Accounting for Uncertainty in Income Taxes". This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We do not expect the adoption of FIN 48 to have a material impact on our results of operations and financial condition.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standard No. 123R “Accounting for Stock-Based Compensation” (SFAS 123R) utilizing the modified prospective approach. Under the modified prospective approach, SFAS 123R applies to new stock-based compensation awards and to awards that were outstanding on January 1, 2006, that are subsequently modified, repurchased or cancelled. Under the fair value recognition provisions of this statement we use the Black-Scholes option-pricing model to determine the fair value of our share-based compensation awards. This model employs the following key assumptions. Expected volatility is based on the annualized daily historical volatility of our stock price, over the expected life of the option. Expected term of the option is based on historical employee stock option exercise behavior, the vesting terms of the respective option and a contractual life of ten years. Our stock price volatility and option lives and expected dividends involve management’s best estimates at that time, all of which impact the fair value of the option calculated under the Black-Scholes methodology and, ultimately, the expense that will be recognized over the life of the option.

SFAS 123R also requires that we recognize compensation expense for only the portion of options or stock units that are expected to vest. In order to determine the portion of options and stock units expected to vest, we apply estimated forfeiture rates that are derived from historical employee termination behavior.

If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

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. Currently, the non-GAAP financial measure that we disclose is EBITDA, which is our net income (loss) before interest, income taxes, depreciation and amortization. We disclose EBITDA 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 future results of operations to our previously reported results of operations.

We view EBITDA as an operating performance measure and as such we believe that the GAAP financial measure most directly comparable to it is net income (loss). In calculating EBITDA 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 is not a measurement 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 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 reconciliation of EBITDA to net income (loss) set forth below, in our earnings releases and in other filings with the Securities and Exchange Commission and 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.

EBITDA is used by management to internally measure our operating and management performance and by investors as a supplemental financial measure to evaluate the performance of our business that, when viewed with our GAAP results and the accompanying reconciliation, we believe provides additional information that is useful to gain an understanding of the factors and trends affecting our business. We have spent more than 18 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complimentary businesses.

Due to the expansion of our information services, which included acquisitions, our net income (loss) has included significant charges for purchase amortization, depreciation and other amortization. EBITDA excludes these charges and provides meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization. We believe the disclosure of EBITDA helps investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe EBITDA is a measure of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and non-operating items, such as interest and income taxes, 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 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 tradenames. 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.

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

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 of dollars):

	Fiscal Year Ended December 31,		
	2004	2005	2006
Net income	\$ 24,985	\$ 6,457	\$ 12,410
Purchase amortization in cost of revenues	2,453	1,250	1,205
Purchase amortization in operating expenses	4,351	4,469	4,183
Depreciation and other amortization	6,206	5,995	6,421
Interest income, net	(1,314)	(3,455)	(6,845)
Income tax (benefit) expense	(16,925)	4,340	8,516
EBITDA	<u>\$ 19,756</u>	<u>\$ 19,056</u>	<u>\$ 25,890</u>
Cash flows provided by (used in)			
Operating activities	\$ 24,723	\$ 22,919	\$ 32,751
Investing activities	\$ (29,946)	\$ (38,732)	\$ (28,493)
Financing activities	\$ 6,297	\$ 7,412	\$ 5,582

Consolidated Results of Operations

The following table provides our selected consolidated results of operations for the indicated periods (in thousands of dollars and as a percentage of total revenue):

	Fiscal Year Ended December 31,					
	2004		2005		2006	
Revenues	\$ 112,085	100.0%	\$ 134,338	100.0%	\$ 158,889	100.0%
Cost of revenues	35,384	31.6	44,286	33.0	56,136	35.3
Gross margin	<u>76,701</u>	<u>68.4</u>	<u>90,052</u>	<u>67.0</u>	<u>102,753</u>	<u>64.7</u>
Operating expenses:						
Selling and marketing	29,458	26.3	38,351	28.6	41,774	26.3
Software development	8,492	7.6	10,123	7.5	12,008	7.6
General and administrative	27,654	24.6	27,550	20.5	30,707	19.3
Restructuring charge	34	0.0	2,217	1.7	34	0.0
Purchase amortization	4,351	3.9	4,469	3.3	4,183	2.6
Total operating expenses	<u>69,955</u>	<u>62.4</u>	<u>82,710</u>	<u>61.6</u>	<u>88,672</u>	<u>55.8</u>
Income from operations	<u>6,746</u>	<u>6.0</u>	<u>7,342</u>	<u>5.4</u>	<u>14,081</u>	<u>8.9</u>
Other income	1,314	1.2	3,455	2.6	6,845	4.3
Income before income taxes	8,060	7.2	10,797	8.0	20,926	13.2
Income tax expense (benefit)	(16,925)	(15.1)	4,340	3.2	8,516	5.4
Net income	<u>\$ 24,985</u>	<u>22.3%</u>	<u>\$ 6,457</u>	<u>4.8%</u>	<u>\$ 12,410</u>	<u>7.8%</u>

Business Segments

Effective in 2007, the Company began to manage the business geographically in two operating segments with our primary areas of measurement and decision-making being the United States and International. Presented below is segment revenue and EBITDA for comparison purposes (in thousands):

	Fiscal Year Ended December 31,		
	2004	2005	2006
Revenues			
United States	\$ 102,607	\$ 123,360	\$ 146,073
International	9,478	10,978	12,816
Total Revenues	<u>\$ 112,085</u>	<u>\$ 134,338</u>	<u>\$ 158,889</u>
EBITDA			
United States	\$ 20,159	\$ 19,372	\$ 26,205
International	(403)	(316)	(315)
Total EBITDA	<u>\$ 19,756</u>	<u>\$ 19,056</u>	<u>\$ 25,890</u>
Reconciliation of EBITDA to net income			
EBITDA	\$ 19,756	\$ 19,056	\$ 25,890
Purchase amortization in cost of revenues	(2,453)	(1,250)	(1,205)
Purchase amortization in operating expenses	(4,351)	(4,469)	(4,183)
Depreciation and other amortization	(6,206)	(5,995)	(6,421)
Interest income, net	1,314	3,455	6,845
Income tax expense, net	16,925	(4,340)	(8,516)
Net income	<u>\$ 24,985</u>	<u>\$ 6,457</u>	<u>\$ 12,410</u>

International EBITDA includes a corporate allocation of approximately \$1.0 million for the years ended December 31, 2006, 2005 and 2004. The corporate allocation represents costs allocated for services for United States employees involved in international management activities.

Comparison of Year Ended December 31, 2006 and Year Ended December 31, 2005

Revenues. Revenues grew 18.3% from \$134.3 million in 2005 to \$158.9 million in 2006. This increase in revenue is principally due to further penetration of our subscription-based information services, as well as the successful cross-selling to our customer base across our service platform in existing markets combined with continued high renewal rates. Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate 96% of our total revenues.

Gross Margin. Gross margin increased from \$90.1 million in 2005 to \$102.8 million in 2006. Gross margin percentage decreased from 67.0% in 2005 to 64.7% in 2006. The increase in the gross margin amount resulted principally from internal revenue growth from our subscription-based information services, partially offset by an increase in cost of revenues. Cost of revenues increased from \$44.3 million in 2005 to \$56.1 million in 2006, principally due to increased research department hiring, training, compensation and other operating costs and the addition of offshore resources from our geographic and retail expansion, as well as research costs associated with further service enhancements to our existing platform.

Selling and Marketing Expenses. Selling and marketing expenses increased from \$38.4 million in 2005 to \$41.8 million in 2006 and decreased as a percentage of revenues from 28.6% in 2005 to 26.3% in 2006. The increase in the amount of selling and marketing expenses is primarily due to sales and marketing efforts for our current retail and geographic expansion plan as well as costs associated with growth in the sales force. Additionally, stock-based compensation expense, due to the implementation of SFAS 123R, included in selling and marketing expenses for the year ended December 31, 2005, was \$19,000 compared to approximately \$1.3 million for the year ended December 31, 2006.

Software Development Expenses. Software development expenses increased from \$10.1 million in 2005 to \$12.0 million in 2006 and remained relatively consistent as a percentage of revenues from 7.5% in 2005 to 7.6% in 2006. The majority of the increase in the amount of software and development expense was due to the hiring of new employees to support our continued focus on enhancements to our existing services, development of new services and development costs for our internal information systems.

General and Administrative Expenses. General and administrative expenses increased from \$27.6 million in 2005 to \$30.7 million in 2006 and decreased as a percentage of revenues from 20.5% in 2005 to 19.3% in 2006. The increase in the amount of general and administrative expenses was primarily due to an increase in stock-based compensation, due to the implementation of SFAS 123R, from \$290,000 in 2005 to \$2.4 million for the year ended 2006 and an increase in professional services.

Restructuring Charge. In the third quarter of 2005, we recorded a restructuring charge of approximately \$2.2 million in connection with the closing of our research center in Mason, Ohio. The restructuring charge included amounts for wages, severance, occupancy and other costs. We did not incur any restructuring charges in 2006.

Purchase Amortization. Purchase amortization decreased from \$4.5 million in 2005 to \$4.2 million in 2006. This decrease was due to the completion of amortization for certain identifiable intangible assets during 2006.

Other Income. Interest income increased from \$3.5 million in 2005 to \$6.8 million in 2006. This increase was primarily a result of higher total cash, cash equivalents and short-term investment balances and increased interest rates during the year.

Income Tax Expense. Income tax expense increased from \$4.3 million in 2005 to of \$8.5 million in 2006. As a result of our increased profitability.

Business Segment Results

Due to the increased size, complexity, and funding requirements associated with our international expansion in 2007, we began to manage our business geographically in two operating segments, with our primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France. Below is a discussion of segment revenue and EBITDA which is provided for comparison purposes. Management relies on an internal management reporting process that provides revenue and segment EBITDA, which is our net income before interest, income taxes, depreciation and amortization. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of our 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 income from operations or other measures of financial performance prepared in accordance with GAAP.

Segment Revenues. United States revenues increased from \$123.4 million for the year ended December 31, 2005 to \$146.1 million for the year ended December 31, 2006. This increase in United States revenue is due to further penetration of our United States subscription-based information services and the successful cross-selling into our customer base across our service platform in existing markets, combined with continued high renewal rates. International revenues increased from \$11.0 million for the year ended December 31, 2005 to \$12.8 million for the year ended December 31, 2006. This increase in international revenue is principally a result of further penetration of our subscription-based information services.

Segment EBITDA. United States EBITDA increased from \$19.4 million for the year ended December 31, 2005 to \$26.2 million for the year ended December 31, 2006. The increase in United States EBITDA was due to increased revenue, partially offset by increased costs associated with our geographic and retail expansion, and an increase in stock based compensation expense due to the implementation of SFAS 123R. Additionally there was a restructuring charge, of approximately \$2.2 million, in 2005 that did not occur in 2006. International EBITDA remained consistent at a loss of approximately \$300,000 for the year ended December 31, 2005 and the year ended December 31, 2006. International EBITDA includes a corporate allocation of approximately \$1.0 million for the year ended December 31, 2005 and the year ended December 31, 2006. The corporate allocation represents costs allocated for services for United States employees involved in international management activities.

Comparison of Year Ended December 31, 2005 and Year Ended December 31, 2004

Revenues. Revenues grew 19.9% from \$112.1 million in 2004 to \$134.3 million in 2005. The increase in revenue is principally due to further penetration of our subscription-based information services, as well as the successful cross-selling to our customer base across our service platform in existing markets combined with continued high renewal rates. In addition, NRB, which was acquired in January 2005, contributed approximately \$1.9 million of our revenues for the year ended December 31, 2005. In 2005, our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, generated 95% of our total revenues.

Gross Margin. Gross margin increased from \$76.7 million in 2004 to \$90.1 million in 2005. Gross margin percentage decreased from 68.4% in 2004 to 67.0% in 2005. The increase in the gross margin amount resulted principally from internal revenue growth from our subscription-based information services. Cost of revenues increased from \$35.4 million in 2004 to \$44.3 million in 2005, principally due to increased research department hiring, training, compensation and other operating costs associated with our 21-market and retail expansion, as well as research costs associated with further service enhancements to our existing platform.

Selling and Marketing Expenses. Selling and marketing expenses increased from \$29.5 million in 2004 to \$38.4 million in 2005 and increased as a percentage of revenues from 26.3% in 2004 to 28.6% in 2005. The increase in the amount of selling and marketing expenses was primarily due to increased sales commissions and growth in the sales force as well as costs associated with sales and marketing efforts for our 21-market and retail expansion plan.

Software Development Expenses. Software development expenses increased from \$8.5 million in 2004 to \$10.1 million in 2005 and decreased as a percentage of revenues from 7.6% in 2004 to 7.5% in 2005. The majority of the increase in the amount of software and development expense was due to the hiring of new employees to support our continued focus on enhancements to our existing services, development of new services and development costs for our internal information systems.

General and Administrative Expenses. General and administrative expenses decreased slightly from \$27.7 million in 2004 to \$27.6 million in 2005 and decreased as a percentage of revenues from 24.6% in 2004 to 20.5% in 2005. The decrease in the percentage of general and administrative expenses was primarily due to our continued efforts to control and leverage our overhead costs.

Restructuring Charge. In the third quarter of 2005, we recorded a restructuring charge of approximately \$2.2 million in connection with the closing of our research center in Mason, Ohio. The restructuring charge included amounts for wages, severance, occupancy and other costs. We did not incur any restructuring charges in 2004.

Purchase Amortization. Purchase amortization increased from \$4.4 million in 2004 to \$4.5 million in 2005. This increase was due to additional amortization associated with the NRB purchase..

Other Income. Interest income increased from \$1.3 million in 2004 to \$3.5 million in 2005. This increase was primarily a result of higher total cash, cash equivalents and short-term investment balances and increased interest rates during the year.

Income Tax Expense (Benefit). Income tax expense (benefit) changed from a benefit of \$16.9 million in 2004 to an expense of \$4.3 million in 2005. Income tax expense in 2005 is a result of our continued profitability combined with the release of the valuation allowance on deferred tax assets in the fourth quarter of 2004.

Business Segment Results

Due to the increased size, complexity, and funding requirements associated with our international expansion in 2007, we began to manage our business geographically in two operating segments, with our primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France. Management relies on an internal management reporting process that provides revenue and segment EBITDA, which is our net income before interest, income taxes, depreciation and amortization. Below is a discussion of segment revenue and EBITDA which is provided for comparison purposes. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of our 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 income from operations or other measures of financial performance prepared in accordance with GAAP.

Segment Revenues. United States revenues increased from \$102.6 million for the year ended December 31, 2004 to \$123.4 million for the year ended December 31, 2005. This increase in United States revenue is due to further penetration of our United States subscription-based information services and the successful cross-selling into our customer base across our service platform in existing markets, combined with continued high renewal rates. International revenues increased from \$9.5 million for the year ended December 31, 2004 to \$11.0 million for the year ended December 31, 2005. This increase in international revenue is principally a result of further penetration of our subscription-based information services.

Segment EBITDA. United States EBITDA decreased from \$20.2 million for the year ended December 31, 2004 to \$19.4 million for the year ended December 31, 2005. The decrease in United States EBITDA was due to increased expenses related to our 21-market and retail expansion efforts, and the one time restructuring charge, of approximately \$2.2 million, for the closing of our research center in Mason, Ohio which occurred in 2005, partially offset by increased revenues. International EBITDA remained relatively consistent at a loss of approximately \$400,000 for the year ended December 31, 2004 to a loss of \$300,000 for the year ended December 31, 2005. International EBITDA includes a corporate allocation of approximately \$1.0 million for the year ended December 31, 2004 and the year ended December 31, 2005. The corporate allocation represents costs allocated for services for United States employees involved in international management activities.

Consolidated Quarterly Results of Operations

The following tables summarize our consolidated results of operations on a quarterly basis for the indicated periods (in thousands, except per share amounts, and as a percentage of total revenues):

	2005				2006			
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31
Revenues	\$ 31,343	\$ 32,871	\$ 34,320	\$ 35,804	\$ 37,274	\$ 38,946	\$ 40,571	\$ 42,098
Cost of revenues	10,490	10,836	11,001	11,959	12,926	12,606	14,005	16,599
Gross margin	20,853	22,035	23,319	23,845	24,348	26,340	26,566	25,499
Operating expenses	19,839	20,818	22,347	19,706	22,500	23,942	20,730	21,500
Income from operations	1,014	1,217	972	4,139	1,848	2,398	5,836	3,999
Other income, net	604	719	932	1,200	1,426	1,610	1,852	1,957
Income before income taxes	1,618	1,936	1,904	5,339	3,274	4,008	7,688	5,956
Income tax expense	644	793	767	2,136	1,414	1,704	2,990	2,408
Net income	\$ 974	\$ 1,143	\$ 1,137	\$ 3,203	\$ 1,860	\$ 2,304	\$ 4,698	\$ 3,548
Net income per share - basic	\$ 0.05	\$ 0.06	\$ 0.06	\$ 0.17	\$ 0.10	\$ 0.12	\$ 0.25	\$ 0.19
Net income per share - diluted	\$ 0.05	\$ 0.06	\$ 0.06	\$ 0.17	\$ 0.10	\$ 0.12	\$ 0.25	\$ 0.18

	2005				2006			
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of revenues	33.5	33.0	32.1	33.4	34.7	32.4	34.5	39.4
Gross margin	66.5	67.0	67.9	66.6	65.3	67.6	65.5	60.6
Operating expenses	63.3	63.3	65.1	55.0	60.3	61.4	51.1	51.1
Income from operations	3.2	3.7	2.8	11.6	5.0	6.2	14.4	9.5
Other income, net	2.0	2.2	2.7	3.3	3.8	4.1	4.6	4.6
Income before income taxes	5.2	5.9	5.5	14.9	8.8	10.3	19.0	14.1
Income tax expense	2.1	2.4	2.2	6.0	3.8	4.4	7.4	5.7
Net income	3.1%	3.5%	3.3%	8.9%	5.0%	5.9%	11.6%	8.4%

Recent Acquisitions

National Research Bureau. On January 20, 2005, we acquired the assets of NRB, a leading provider of property information to the shopping center industry, from Claritas Inc. for approximately \$4.1 million in cash.

Grecam S.A.S. On December 21, 2006, our U.K. Subsidiary, CoStar Limited, acquired Grecam, a provider of commercial property information and market-level surveys, studies and consulting services, located in Paris, France. We acquired all of the assets of Grecam, together with all outstanding capital stock for approximately \$2.0 million in cash.

Property Investment Exchange. On February 16, 2007, CoStar Limited, a wholly owned U.K. subsidiary of CoStar, acquired all outstanding capital stock of Propex, a U.K. company, from the shareholders of Propex pursuant to a Stock Purchase Agreement in exchange for consideration of approximately £11,000,000 (approximately \$22.0 million), consisting of cash and 21,526 shares of CoStar common stock. The purchase price is subject to decrease based on Propex's net worth as of the closing date. Propex provides web-based commercial property information and operates an electronic platform that facilitates the exchange of investment property in the U.K. Its suite of electronic platforms and listing websites give users access to the U.K. commercial property investment and leasing markets.

Accounting Treatment. All of the acquisitions discussed above have been accounted for using purchase accounting. The purchase price for each of the acquisitions was allocated primarily to acquired database technology, customer base and goodwill. The acquired database technology for each acquisition is being amortized on a straight-line basis over 5 years. The customer base for each acquisition, which consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over 10 years. Goodwill will not be amortized, but is subject to annual impairment tests. The results of operations of NRB and Grecam have been consolidated with our results since the respective dates of acquisition. The operating results of each of NRB and Grecam are not considered material to our consolidated financial statements, and accordingly, pro forma financial information has not been presented for any of the acquisitions.

CoStar currently operates within one business segment. Due to the purchase of Grecam in December of 2006, the purchase of Propex in February of 2007 and the Company's plan to expand the U.K. operations in 2007, the Company will operate in more than one segment in 2007.

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 were \$158.1 million at December 31, 2006 compared to \$134.2 million at December 31, 2005. Cash, cash equivalents and short-term investments increased principally as a result of EBITDA, interest income, and proceeds from exercise of stock options, partially offset by purchases of property and equipment and other assets, cash used for the purchase of Grecam, and changes in working capital accounts.

Net cash provided by operating activities for the year ended December 31, 2006 was \$32.8 million compared to \$22.9 million for the year ended December 31, 2005. The \$9.9 million increase in net cash provided by operating activities is primarily due to increased earnings before non-cash charges for taxes, stock based compensation, provision for losses on accounts receivable, depreciation and amortization, partially offset by the net effect of changes in working capital.

Net cash used in investing activities was \$28.5 million for the year ended December 31, 2006 compared to \$38.7 million for the year ended December 31, 2005. This \$10.2 million decrease in net cash used in investing activities was principally due to decreased net purchases and sales of short-term investments and less cash used in acquisitions, partially offset by increased purchases of property and equipment and other assets.

Net cash provided by financing activities was \$5.6 million for the year ended December 31, 2006 compared to \$7.4 million for the year ended December 31, 2005. The lower net cash produced by financing activities in 2006 compared to 2005 is due to a decrease in proceeds from the exercise of stock options.

Contractual Obligations. The following table summarizes our principal contractual obligations at December 31, 2006 and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in thousands):

	Total	2007	2008-2009	2010-2011	2012 and thereafter
Operating leases	\$ 28,634	\$ 7,563	\$ 12,922	\$ 5,735	\$ 2,414
Purchase obligations ⁽¹⁾	3,592	3,076	513	3	¾
Total contractual principal cash obligations	\$ 32,226	\$ 10,639	\$ 13,435	\$ 5,738	\$ 2,414

(1) Amounts do not include current purchase obligations that may be renewed on the same or different terms or terminated by us or a third party.

During 2006, we incurred capital expenditures of approximately \$13.0 million, including expenditures of approximately \$7.8 million related to building photography costs and the purchase of field research vehicles and equipment in connection with our intention to actively research commercial properties in approximately 100 new MSA's across the United States, and the remaining \$5.2 million related to costs of supporting our existing operations. We expect to make capital expenditures in 2007 totaling approximately \$12.0 million including significant investments in expansion facilities, building photography, network equipment and workstations to support expansion and ongoing operations. This estimate also includes \$2.0 million to \$3.0 million in capital expenditures for the company's U.K. operations..

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 expect to use cash, stock, debt or other means of funding to make these acquisitions.

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

As of the fourth quarter of 2004, we determined that it was more likely than not that we would generate taxable income from operations and be able to realize tax benefits arising from use of our net operating loss carryforwards to reduce the income tax we will owe on this taxable income. Prior to the fourth quarter of 2004, we recorded a valuation allowance on the deferred tax assets associated with these future tax benefits because we were not certain we would generate taxable income in the future. The release of the valuation allowance in the fourth quarter of 2004 resulted in a tax benefit of approximately \$26.2 million. This included an income tax benefit of approximately \$16.7 million that was recognized in our results from operations. We also recognized a tax benefit of approximately \$9.5 million as additional paid-in capital for our net operating loss carryforwards attributable to tax deductions for stock options. As of December 31, 2006, we continued to maintain a valuation allowance of approximately \$337,000 for certain state net operating loss carryforwards. At December 31, 2006, we had net operating loss carryforwards for federal income tax purposes of approximately \$43.1 million, which expire, if unused, from the year 2013 through the year 2023.

For the next two years, however, we expect the majority of our taxable income to be absorbed by our net operating loss carryforwards. As a result, we expect our cash payments for taxes to be limited primarily to federal alternative minimum taxes and to state income taxes in certain states.

Inflation may affect the way we operate in the U.S. and abroad. In general, we believe that over time we are able to increase the prices of our services to counteract the majority of the inflationary effects of increasing costs. We do not believe the impact of inflation has significantly affected our operations, and we do not anticipate that inflation will have a material impact on our operations in 2007.

Recent Accounting Pronouncements

We initially adopted the Emerging Issues Task Force (“EITF”) consensus on Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” on July 1, 2004, and the Financial Accounting Standards Board Staff Position (“FSP”) EITF Issue No. 03-1-1, Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” on September 30, 2004. The consensus on Issue No. 03-1 applies to investments in marketable debt and equity securities, as well as investments in equity securities accounted for under the cost method. It provides guidance for determining when an investment is considered impaired, whether the impairment is other than temporary, and the measurement of an impairment loss. The guidance also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP EITF Issue No. 03-1-1 delays the effective date of paragraphs 10-20 of EITF Issue No. 03-1, which provide guidance for determining whether the impairment is other than temporary, the measurement of an impairment loss, and accounting considerations subsequent to the recognition of an other-than-temporary impairment. Application of these paragraphs was deferred pending issuance of proposed FSP EITF Issue No. 03-1-a. The adoption of EITF Issue No. 03-1 and FSP EITF Issue No. 03-1-1 did not have a material impact on our results of operations and financial condition. On November 3, 2005 the Financial Accounting Standards Board (“FASB”) issued FSP EITF Issue No. 03-1-a (renamed as FSP FAS 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”), which provides guidance effective for fiscal periods beginning after December 15, 2005. The adoption of this pronouncement has not had a material impact on our results of operations and financial condition.

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions” (“SFAS 153”). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, “Accounting for Nonmonetary Transactions,” and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for the fiscal periods beginning after September 15, 2005 and we were required to adopt it beginning January 1, 2006. The adoption of SFAS 153 did not have a material impact on our results of operations and financial condition.

In March 2005, the FASB issued FIN No. 47, “Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143 “Accounting for Asset Retirement Obligations (“SFAS 143”)” (“FIN 47”).” FIN 47 clarifies that the term conditional asset retirement obligation as used in SFAS 143 refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any uncertainty about the amount and/or timing of future settlement should be factored into the measurement of the liability when sufficient information exists. The liability for the conditional asset retirement obligation should be recognized when incurred. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 is effective for fiscal periods beginning after December 15, 2005. The adoption of FIN 47 did not have a material impact on our results of operations and financial condition.

In May 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3” (“SFAS 154”). SFAS 154 replaces APB Opinion No. 20, “Accounting Changes” and SFAS No. 3, “Reporting Accounting Changes in Interim Financial Statements,” and changes the requirements for accounting for and reporting a change in accounting principle. SFAS 154 requires restatement of prior period financial statements, unless impracticable, for voluntary changes in accounting principle. The retroactive application of a change in accounting principle should be limited to the direct effect of the change. Changes in depreciation, amortization or depletion methods should be accounted for prospectively as a change in accounting estimate. Corrections of accounting errors will be accounted for under the guidance contained in APB Opinion No. 20. The effective date of this new pronouncement is for fiscal years beginning after December 15, 2005 and prospective application is required. The adoption of SFAS 154 did not have a material impact on our results of operations and financial condition.

In June 2006, the FASB issued FASB Interpretation No. 48 (“FIN 48”) “Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109”, to clarify certain aspects of accounting for uncertain tax positions, including issues related to the recognition and measurement of those tax positions. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” or “SFAS 157”, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles (“GAAP”) in the United States of America, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements under GAAP and is effective for fiscal years beginning after November 15, 2007. The effects of adoption will be determined by the types of instruments carried at fair value in our financial statements at the time of adoption as well as the method utilized to determine their fair values prior to adoption. Based on our current use of fair value measurements, SFAS 157 is not expected to have a material effect on our results of operations or financial position.

COSTAR GROUP, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Reports of Independent Registered Public Accounting Firm	F-2
Consolidated Statements of Operations for the years ended December 31, 2004, 2005 and 2006	F-3
Consolidated Balance Sheets as of December 31, 2005 and 2006	F-4
Consolidated Statements of Stockholders' Equity for the years ended December 31, 2004, 2005 and 2006	F-5
Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006	F-6
Notes to Consolidated Financial Statements	F-7

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of CoStar Group, Inc.:

We have audited the accompanying consolidated balance sheets of CoStar Group, Inc., as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CoStar Group, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Oversight Board (United States), the effectiveness of CoStar Group, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 19, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

McLean, Virginia
February 19, 2007 (June 22, 2007 as to the change in operating segments described in Note 14)

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

	Year Ended December 31,		
	2004	2005	2006
Revenues	\$ 112,085	\$ 134,338	\$ 158,889
Cost of revenues	35,384	44,286	56,136
Gross margin	76,701	90,052	102,753
Operating expenses:			
Selling and marketing	29,458	38,351	41,774
Software development	8,492	10,123	12,008
General and administrative	27,654	27,550	30,707
Restructuring charge	¾	2,217	¾
Purchase amortization	4,351	4,469	4,183
	69,955	82,710	88,672
Income from operations	6,746	7,342	14,081
Other income:			
Interest income	1,314	3,455	6,845
Income before income taxes	8,060	10,797	20,926
Income tax (benefit) expense	(16,925)	4,340	8,516
Net income	\$ 24,985	\$ 6,457	\$ 12,410
Net income per share ¾ basic	\$ 1.38	\$ 0.35	\$ 0.66
Net income per share ¾ diluted	\$ 1.33	\$ 0.34	\$ 0.65
Weighted average outstanding shares ¾ basic	18,165	18,453	18,751
Weighted average outstanding shares ¾ diluted	18,827	19,007	19,165

See accompanying notes.

COSTAR GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands except per share data)

	December 31,	
	2005	2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 28,065	\$ 38,159
Short-term investments	106,120	119,989
Accounts receivable, less allowance for doubtful accounts of approximately \$1,602 and \$1,966 as of December 31, 2005 and 2006	5,673	9,202
Deferred income taxes, net	4,475	7,904
Prepaid expenses and other current assets	2,205	3,497
Total current assets	146,538	178,751
Deferred income taxes, net	18,690	6,973
Property and equipment, net	15,144	18,407
Goodwill, net	43,563	46,497
Intangibles and other assets, net	22,847	23,172
Deposits	1,277	1,637
Total assets	<u>\$ 248,059</u>	<u>\$ 275,437</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,484	\$ 1,878
Accrued wages and commissions	4,640	6,018
Accrued expenses	6,742	6,098
Deferred revenue	7,638	8,817
Deferred rent	1,533	1,334
Total current liabilities	22,037	24,145
Deferred income taxes, net	1,226	1,182
Stockholders' equity:		
Preferred stock, \$0.01 par value; 2,000 shares authorized; none outstanding	¾	¾
Common stock, \$0.01 par value; 30,000 shares authorized; 18,674 and 19,081 issued and outstanding as of December 31, 2005 and 2006	187	191
Additional paid-in capital	295,920	302,936
Accumulated other comprehensive income	1,348	4,520
Unearned compensation	(2,712)	¾
Accumulated deficit	(69,947)	(57,537)
Total stockholders' equity	224,796	250,110
Total liabilities and stockholders' equity	<u>\$ 248,059</u>	<u>\$ 275,437</u>

See accompanying notes.

COSTAR GROUP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Comprehensive Income	Common Stock		Additional Paid-In Capital	Unearned Compensation	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders' Equity
		Shares	Amount					
Balance at December 31, 2003		17,877	\$ 179	\$ 267,183	\$ ¾	\$ 2,396	\$ (101,389)	\$ 168,369
Net income	\$ 24,985	¾	¾	¾	¾	¾	24,985	24,985
Foreign currency translation adjustment	1,729	¾	¾	¾	¾	1,729	¾	1,729
Net unrealized loss on short-term investments	(166)	¾	¾	¾	¾	(166)	¾	(166)
Comprehensive income	<u>\$ 26,548</u>							
Exercise of stock options		421	4	6,293	¾	¾	¾	6,297
Release of valuation allowance related to the deferred tax benefit for exercised stock options		¾	¾	9,523	¾	¾	¾	9,523
Stock issued for PeerMark acquisition		5	¾	207	¾	¾	¾	207
Balance at December 31, 2004		18,303	183	283,206	¾	3,959	(76,404)	210,944
Net income	6,457	¾	¾	¾	¾	¾	6,457	6,457
Foreign currency translation adjustment	(2,431)	¾	¾	¾	¾	(2,431)	¾	(2,431)
Net unrealized loss on short-term investments	(180)	¾	¾	¾	¾	(180)	¾	(180)
Comprehensive income	<u>\$ 3,846</u>							
Exercise of stock options		299	3	7,409	¾	¾	¾	7,412
Deferred tax benefit for exercised stock options		¾	¾	2,215	¾	¾	¾	2,215
Restricted stock		72	1	3,090	(3,091)	¾	¾	¾
Amortization of unearned compensation		¾	¾	¾	379	¾	¾	379
Balance at December 31, 2005		18,674	187	295,920	(2,712)	1,348	(69,947)	224,796
Net income	12,410	¾	¾	¾	¾		12,410	12,410
Foreign currency translation adjustment	2,950	¾	¾	¾	¾	2,950	¾	2,950
Net unrealized loss on short-term investments	222	¾	¾	¾	¾	222	¾	222
Comprehensive income	<u>\$ 15,582</u>							
Exercise of stock options		270	3	6,566	¾	¾	¾	6,569
Swaps of shares for exercise		(20)	(1)	(938)	¾	¾	¾	(939)
Restricted stock grants		165	2	34	¾	¾	¾	36
Restricted stock grants surrendered		(12)	¾	(234)	¾	¾	¾	(234)
Stock compensation expense, net of forfeitures		¾	¾	4,094	¾	¾	¾	4,094
Employee Stock Purchase Plan		4	¾	206	¾	¾	¾	206
Impact upon adoption of SFAS 123R		¾	¾	(2,712)	2,712	¾	¾	¾
Balance at December 31, 2006		<u>19,081</u>	<u>\$ 191</u>	<u>\$ 302,936</u>	<u>\$ ¾</u>	<u>\$ 4,520</u>	<u>\$ (57,537)</u>	<u>\$ 250,110</u>

See accompanying notes.

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

	Year Ended December 31,		
	2004	2005	2006
Operating activities:			
Net income	\$ 24,985	\$ 6,457	\$ 12,410
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	5,525	5,725	5,734
Amortization	7,485	5,989	6,076
Income tax (benefit) expense	(17,052)	4,245	7,658
Provision for losses on accounts receivable	401	979	1,813
Stock based compensation expense	34	379	4,155
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	117	(2,652)	(5,080)
Prepaid expenses and other current assets	98	(330)	(1,205)
Deposits	(11)	(317)	(246)
Accounts payable and accrued expenses	3,064	1,683	688
Deferred revenue	111	761	748
Net cash provided by operating activities	24,723	22,919	32,751
Investing activities:			
Purchases of short-term investments	(90,588)	(250,272)	(109,040)
Sales of short-term investments	71,944	224,234	95,393
Purchases of property and equipment and other assets	(9,032)	(8,393)	(12,959)
Acquisitions, net of acquired cash	(2,270)	(4,301)	(1,887)
Net cash used in investing activities	(29,946)	(38,732)	(28,493)
Financing activities:			
Exercise of stock options	6,297	7,412	5,582
Net cash provided by financing activities	6,297	7,412	5,582
Effect of foreign currency exchange rates on cash and cash equivalents	90	(341)	254
Net increase (decrease) in cash and cash equivalents	1,164	(8,742)	10,094
Cash and cash equivalents at beginning of year	35,643	36,807	28,065
Cash and cash equivalents at end of year	\$ 36,807	\$ 28,065	\$ 38,159
Supplemental disclosure of non-cash transactions:			
Deferred tax benefit for exercised stock options	\$ 9,523	\$ 2,215	\$ 34

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006

1. ORGANIZATION

CoStar Group, Inc. (the “Company”) has created a comprehensive, proprietary database of commercial real estate information for metropolitan areas throughout the United States, United Kingdom and France. Based on its unique database, the Company provides information services to the commercial real estate and related business community in the United States, United Kingdom and France. Historically, the Company has operated in one segment. Due to the increased size, complexity, and funding requirements associated with the international expansion in 2007, the Company began to manage its business geographically in two operating segments, with the primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France. The information services are typically distributed to its clients under subscription-based license agreements, which have a minimum term of one year and renew automatically.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

Reclassifications

Certain previously reported amounts have been reclassified to conform to the Company's current presentation.

Revenue Recognition

The Company primarily derives revenues from providing access to its proprietary database of commercial real estate information. The Company generally charges a fixed monthly amount for its subscription-based services. Subscription contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Subscription-based license agreements typically have a minimum term of one year and renew automatically.

Revenues from subscription-based services are recognized on a straight-line basis over the term of the agreement. Deferred revenue results from advance cash receipts from customers or amounts billed in advance to customers from the sales of subscription licenses and is recognized over the term of the license.

Cost of Revenues

Cost of revenues principally consists of salaries and related expenses for the Company's researchers who collect and analyze the commercial real estate data that is the basis for the Company's information services. Additionally, cost of revenues includes the cost of data from third-party data sources, which is expensed as incurred, and the amortization of database technology.

Significant Customers

No single customer accounted for more than 5% of the Company's revenues for each of the years ended December 31, 2004, 2005 and 2006.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

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. Revenue, 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. Net gains or losses resulting from foreign currency exchange transactions are included in the consolidated statement of operations. The Company had an increase (decrease) in comprehensive income of approximately (\$2.4) million and \$3.0 million from the translation of its foreign subsidiary's assets and liabilities into U.S. dollars for the years ended December 31, 2005 and 2006, respectively. There were no material gains or losses from foreign currency exchange transactions for the years ended December 31, 2005 and 2006.

Comprehensive Income

For the years ended December 31, 2004, 2005 and 2006, total comprehensive income was approximately \$26.5 million, \$3.8 million and \$15.6 million, respectively. As of December 31, 2006, accumulated other comprehensive income included foreign currency translation adjustments of approximately \$4.7 million and unrealized losses on short-term investments of approximately \$147,000.

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expense was \$584,000, \$200,000 and \$4.0 million for the years ended December 31, 2004, 2005 and 2006, respectively.

Income Taxes

The Company provides for income taxes under the provisions of Statement of Financial Accounting Standards No. 109 ("SFAS No. 109"). Deferred income taxes result from temporary differences between the tax basis of assets and liabilities and the basis reported in the Company's consolidated financial statements. Deferred tax liabilities and assets are determined based on the difference between financial statement and tax basis of assets and liabilities using enacted rates expected to be in effect during the year in which the differences reverse. Valuation allowances are provided against assets, including net operating losses, if it is anticipated that some or all of the asset may not be realized through future taxable earnings or implementation of tax planning strategies.

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. 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 potential common shares would have an anti-dilutive effect.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R "Share Based Payment" ("SFAS 123R"), which addresses the accounting for share-based payment transactions in which the Company receives employee services in exchange for equity instruments. The statement eliminates the Company's ability to account for share-based compensation transactions as prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and generally requires that equity instruments issued in such transactions be accounted for using a fair-value based method and the fair value of such equity instruments be recognized as expense in the consolidated statements of operations.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

Stock-Based Compensation $\frac{3}{4}$ (Continued)

Under the fair-value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. The Company recognizes compensation costs for awards with graded vesting over the straight-line method.

The Company adopted SFAS 123R using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under SFAS 123 for the periods prior to 2006, the Company accounted for forfeitures as they occurred. Upon adoption of SFAS 123R, the Company recorded a charge of approximately \$35,000 representing the cumulative effect of a change in accounting principle. This amount was recorded in general and administrative expenses in the condensed consolidated statements of operations for the year ended December 31, 2006.

The impact of the adoption of SFAS 123R on the Company's results of operations for the year ended December 31, 2006, was as follows (in thousands, except per share data):

Income from operations	\$	(2,860)
Income before taxes		(2,860)
Net income		(1,784)
Basic earnings per share		(0.10)
Diluted earnings per share	\$	(0.09)

SFAS 123R requires cash flows resulting from excess tax benefits to be classified as part of cash flows from financing activities. Excess tax benefits represent tax benefits related to exercised options in excess of the associated deferred tax asset for such options. There were no excess tax benefits as a result of adopting SFAS 123R for the year ended December 31, 2006, and no amounts were classified as an operating cash outflow or a financing cash inflow in the accompanying condensed consolidated statement of cash flows. Net cash proceeds from the exercise of stock options were approximately \$6.3 million; \$7.4 million and \$5.6 million for the years ended December 31, 2004, 2005 and 2006, respectively. There was no income tax benefit realized from stock option exercises for the year ended December 31, 2006.

Stock-based compensation expense for stock options and restricted stock included in the Company's results of operations for the years ended December 31, was as follows (in thousands):

	Year Ended December 31,		
	2004	2005	2006
Cost of revenues	\$ $\frac{3}{4}$	\$ 8	\$ 317
Selling and marketing	$\frac{3}{4}$	19	1,263
Software development	$\frac{3}{4}$	29	202
General and administrative	18	290	2,373
Total	\$ 18	\$ 346	\$ 4,155

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

Stock-Based Compensation $\frac{3}{4}$ (Continued)

Prior to the adoption of SFAS 123R, the Company provided the disclosures required under SFAS 123. Employee stock-based compensation expense recognized under SFAS 123R was not reflected in the Company's results of operations for the year ended December 31, 2005. Previously reported amounts have not been restated in the Company's financial statements.

The following table illustrates the pro forma effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123 for the years ended December 31, 2004 and 2005, (in thousands, except per share data):

	Year Ended December 31,	
	2004	2005
Net income, as reported	\$ 24,985	\$ 6,457
Add: stock-based employee compensation expense included in reported net income	11	216
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards	(7,610)	(3,560)
Pro forma net income	<u>\$ 17,386</u>	<u>\$ 3,113</u>
Net income per share:		
Basic $\frac{3}{4}$ as reported	\$ 1.38	\$ 0.35
Basic $\frac{3}{4}$ pro forma	<u>\$ 0.96</u>	<u>\$ 0.17</u>
Diluted $\frac{3}{4}$ as reported	\$ 1.33	\$ 0.34
Diluted $\frac{3}{4}$ pro forma	<u>\$ 0.92</u>	<u>\$ 0.16</u>

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES ¾ (Continued)

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of money market fund investments and United States Government Securities. As of December 31, 2005 and 2006, cash of \$714,000 and \$742,000, respectively, was restricted to support letters of credit for security deposits.

Short-Term Investments

The Company accounts for short-term investments in accordance with Statement of Financial Accounting Standards ("SFAS No. 115), "Accounting for Certain Investments in Debt and Equity Securities." The Company determines the appropriate classification of investments at the time of purchase and reevaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. 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 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. Investments are carried at fair market value.

Scheduled maturities of investments classified as available for sale as of December 31, 2006 are as follows (in thousands):

Maturity	Fair Value
Due in:	
2007	\$ 75,400
2008-2011	25,952
2012-2016	3,159
2017 and thereafter	424
	<u>104,935</u>
Securities with multiple maturities	15,054
Short-term investments	<u>\$ 119,989</u>

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 other comprehensive income 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.

The unrealized losses on the Company's investments as of December 31, 2005 and 2006 were generated primarily from increases 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 has the ability to hold these investments until a recovery of fair value, which may be maturity, it does not consider these investments to be other-than-temporarily impaired as of December 31, 2005 and 2006.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

Short-Term Investments $\frac{3}{4}$ (Continued)

The components of the investments in a loss position for more than twelve months consists of the following (in thousands):

	December 31,			
	2005		2006	
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
Government-sponsored enterprise obligations	\$ 16,428	\$ (195)	\$ 3,810	\$ (56)
Corporate debt securities	2,347	(8)	18,253	(114)
	<u>\$ 18,775</u>	<u>\$ (203)</u>	<u>\$ 22,063</u>	<u>\$ (170)</u>

The components of the investments in a loss position for less than twelve months consists of the following (in thousands):

	December 31,			
	2005		2006	
	Aggregate Fair Value	Gross Unrealized Losses	Aggregate Fair Value	Gross Unrealized Losses
Government-sponsored enterprise obligations	\$ 7,860	\$ (42)	\$ 4,442	\$ (13)
U.S. treasury obligations	156	(1)	$\frac{3}{4}$	$\frac{3}{4}$
Corporate debt securities	24,553	(144)	10,207	(10)
	<u>\$ 32,569</u>	<u>\$ (187)</u>	<u>\$ 14,649</u>	<u>\$ (23)</u>

The gross unrealized gains as of December 31, 2005 and 2006 are approximately \$21,000 and \$50,000 respectively.

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 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, accounts receivable, accounts payable, and accrued expenses approximates fair value.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ³/₄ (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES ³/₄ (Continued)

Property and Equipment

Property and equipment are stated at cost. All repairs and maintenance costs are expensed as incurred. Depreciation and amortization are calculated on the straight-line method over the following estimated useful lives of the assets:

Leasehold improvements	Shorter of lease term or useful life
Furniture and office equipment	Seven years
Research vehicles	Five years
Computer hardware and software	Two to five years

Internal use software costs are capitalized in accordance with Statement of Position No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). Qualifying costs incurred during the application development stage, which consist primarily of outside services and purchased software license costs, are capitalized and amortized over the estimated useful life of the asset. All other costs are expensed as incurred.

Goodwill, Intangibles and Other Assets

Goodwill represents the excess of costs over the fair value of assets of businesses acquired. Goodwill and intangible assets subject to amortization that arose from acquisitions prior to July 1, 2001, have been amortized on a straight-line basis over their estimated useful lives in accordance with Accounting Principles Board Opinion No. 17, "Intangible Assets". The Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), as of January 1, 2002. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 also requires that intangible assets with estimable useful lives that arose from acquisitions on or after July 1, 2001 be amortized over their respective estimated useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets".

Acquired database technology, customer base and tradename are related to the Company's acquisitions (See Notes 3 and 6). Acquired database technology and tradename are amortized on a straight-line basis over periods ranging from two to ten years. The acquired intangible asset characterized as customer base consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships. Customer bases that arose from acquisitions prior to July 1, 2001 are amortized on a straight-line basis principally over a period of ten years. Customer bases that arose from acquisitions on or after July 1, 2001 are amortized on a 125% declining balance method over ten years. The cost of capitalized building photography is amortized on a straight-line basis over five years.

Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset or asset group. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

Long-Lived Assets $\frac{3}{4}$ (Continued)

Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and would no longer be depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" or "SFAS 157", which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles ("GAAP") in the United States of America, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements under GAAP and is effective for fiscal years beginning after November 15, 2007. The effects of adoption will be determined by the types of instruments carried at fair value in the Company's financial statements at the time of adoption as well as the method utilized to determine their fair values prior to adoption. Based on the Company's current use of fair value measurements, SFAS 157 is not expected to have a material effect on the results of operations or financial position of the Company.

In June 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We do not expect the adoption of FIN 48 to have a material impact on our results of operations and financial condition.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R "Share Based Payment" ("SFAS 123R"), which addresses the accounting for share-based payment transactions in which the Company receives employee services in exchange for equity instruments. The statement eliminates the Company's ability to account for share-based compensation transactions as prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and generally requires that equity instruments issued in such transactions be accounted for using a fair-value based method and the fair value of such equity instruments be recognized as expenses in the consolidated statements of operations. The impact of this statement is disclosed in footnote 2.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES $\frac{3}{4}$ (Continued)

New Accounting Pronouncements $\frac{3}{4}$ (Continued)

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 replaces APB Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements," and changes the requirements for accounting for and reporting a change in accounting principle. SFAS 154 requires restatement of prior period financial statements, unless impracticable, for voluntary changes in accounting principle. The retroactive application of a change in accounting principle should be limited to the direct effect of the change. Changes in depreciation, amortization or depletion methods should be accounted for prospectively as a change in accounting estimate. Corrections of accounting errors will be accounted for under the guidance contained in APB Opinion No. 20. The effective date of this new pronouncement is for fiscal years beginning after December 15, 2005 and prospective application is required. The adoption of SFAS 154 did not have a material impact on the Company's results of operations and financial condition.

3. ACQUISITIONS

On January 20, 2005, the Company acquired the assets of National Research Bureau ("NRB"), a leading provider of property information to the shopping center industry, from Claritas Inc. for approximately \$4.1 million in cash. NRB has over 45 years of experience as a leading producer of information to the retail real estate industry, principally through its Shopping Center Directory and Shopping Center Directory on CD-ROM.

On December 21, 2006, the Company's 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. The Company acquired all of the assets of Grecam, together with all outstanding capital stock for approximately \$2.0 million in cash. This amount is preliminary and may be adjusted after the purchase price allocation is complete.

All of the Company's acquisitions have been accounted for using purchase accounting. The purchase price for each acquisition was allocated primarily to acquired database technology, customer base and goodwill. The acquired database technology for each acquisition is being amortized on a straight-line basis over 4 years. The customer base for each acquisition, which consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over 10 years. Goodwill is not amortized, but is subject to annual impairment tests. The results of operations of NRB and Grecam have been consolidated with those of the Company since the respective dates of acquisition and are not considered material to the consolidated financial statements of the Company. Accordingly, pro forma financial information has not been presented for any of the acquisitions.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ¾ (Continued)

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

	December 31,	
	2005	2006
Leasehold improvements	\$ 4,151	\$ 4,450
Furniture, office equipment and research vehicles	12,947	18,171
Computer hardware and software	19,277	21,862
	36,375	44,483
Accumulated depreciation and amortization	(21,231)	(26,076)
Property and equipment, net	\$ 15,144	\$ 18,407

5. GOODWILL

Goodwill consists of the following (in thousands):

	December 31,	
	2005	2006
Goodwill	\$ 54,786	\$ 57,720
Accumulated amortization	(11,223)	(11,223)
Goodwill, net	\$ 43,563	\$ 46,497

The Company recorded goodwill of approximately \$3.4 million for the NRB acquisition in January 2005 and recorded goodwill of approximately \$1.1 million for the Grecam acquisition in December 2006. The remaining increase in goodwill in 2006 is related to foreign currency fluctuations.

During the fourth quarters of 2005 and 2006, the Company completed the annual impairment test of goodwill and concluded that goodwill was not impaired.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

6. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consists of the following (dollars in thousands):

	December 31, 2005	December 31, 2006	Weighted- Average Amortization Period (in years)
Building photography	\$ 5,922	\$ 9,902	5
Accumulated amortization	<u>(4,853)</u>	<u>(5,567)</u>	
Building photography, net	<u>1,069</u>	<u>4,335</u>	
Acquired database technology	20,626	22,101	4
Accumulated amortization	<u>(19,096)</u>	<u>(20,107)</u>	
Acquired database technology, net	<u>1,530</u>	<u>1,994</u>	
Acquired customer base	43,324	44,949	10
Accumulated amortization	<u>(24,804)</u>	<u>(29,414)</u>	
Acquired customer base, net	<u>18,520</u>	<u>15,535</u>	
Acquired tradename	4,198	4,198	10
Accumulated amortization	<u>(2,470)</u>	<u>(2,890)</u>	
Acquired tradename, net	<u>1,728</u>	<u>1,308</u>	
Intangibles and other assets, net	<u>\$ 22,847</u>	<u>\$ 23,172</u>	

Amortization expense for intangibles and other assets was approximately \$7.5 million; \$6.0 million and \$6.1 million for the years ended December 31, 2004, 2005 and 2006, respectively.

In the aggregate, amortization for intangibles and other assets existing as of December 31, 2006 for future periods is expected to be approximately \$6.1 million, \$6.0million, \$4.4 million, \$2.5 million and \$1.5 million for the years ending December 31, 2007, 2008, 2009, 2010 and 2011, respectively.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ¾ (Continued)

7. INCOME TAXES

The components of the provision (benefit) for income taxes attributable to operations consist of the following (in thousands):

	Year Ended December 31,		
	2004	2005	2006
Current:			
Federal	\$ 105	\$ 227	\$ 414
State	22	57	220
Foreign	¾	¾	¾
Total current	<u>127</u>	<u>284</u>	<u>634</u>
Deferred:			
Federal	(13,361)	4,018	7,497
State	(2,764)	746	1,077
Foreign	(927)	(708)	(692)
Total deferred	<u>(17,052)</u>	<u>4,056</u>	<u>7,882</u>
Total provision (benefit) for income taxes	<u>\$ (16,925)</u>	<u>\$ 4,340</u>	<u>\$ 8,516</u>

The components of deferred tax assets and liabilities consists of the following (in thousands):

	December 31,	
	2005	2006
Deferred tax assets:		
Reserve for bad debts	\$ 523	\$ 610
Accrued compensation	1,213	879
Stock compensation	133	776
Net operating losses	24,213	14,747
Restructuring reserve	390	201
Alternative minimum tax credits	425	820
Other liabilities	<u>1,331</u>	<u>1,119</u>
Total deferred tax assets	<u>28,228</u>	<u>19,152</u>
Deferred tax liabilities:		
Prepays	(498)	(644)
Depreciation	(329)	(323)
Identified intangibles associated with purchase accounting	<u>(4,775)</u>	<u>(4,153)</u>
Total deferred tax liabilities	<u>(5,602)</u>	<u>(5,120)</u>
Net deferred tax asset	22,626	14,032
Valuation allowance	<u>(687)</u>	<u>(337)</u>
Net deferred taxes	<u>\$ 21,939</u>	<u>\$ 13,695</u>

The net long-term deferred tax liability shown on the balance sheet includes deferred tax liabilities and assets related to the U.K. operations of the Company.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ¾ (Continued)

7. INCOME TAXES¾ (Continued)

The total net deferred tax asset of approximately \$14.9 million shown on the balance sheet includes the tax liabilities and assets related to the U.S. operations of the Company. The net deferred tax liability related to the U.K. operations is shown separately because the U.K. operations are subject to a separate taxing jurisdiction.

For the years ended December 31, 2005 and 2006, a valuation allowance has been established primarily for certain state net operating loss carryforwards due to the uncertainty of realization. For the year ended December 31, 2004, management determined that because of the continuing improvement of operating results and the Company's outlook for the future it was more likely than not that the Company would realize approximately \$23.1 million of its net deferred tax assets through future taxable earnings. A valuation allowance continued to be established for certain state net operating loss carryforwards due to the uncertainty of realization. Approximately \$9.5 million of the release of the valuation allowance was recorded directly to additional paid-in capital as the related deferred tax asset was generated from the exercise of employee stock options.

The Company's change in valuation allowance was approximately \$140,000 and \$350,000 during the years ended December 31, 2005 and 2006, respectively. For the year ended December 31, 2006, the Company had income of approximately \$23.4 million subject to applicable U.S. federal and state income tax laws and a loss of approximately \$2.5 million subject to applicable U.K. tax laws.

The Company's provision for income taxes resulted in effective tax rates that varied from the statutory federal income tax rate as follows (in thousands):

	Year Ended December 31,		
	2004	2005	2006
Expected federal income tax (benefit) provision at 34%	\$ 2,847	\$ 3,670	\$ 7,115
State income taxes, net of federal benefit	353	533	1,014
Foreign income taxes, net effect	76	139	119
Stock compensation	¾	¾	528
Increase (decrease) in valuation allowance	(20,057)	3	(267)
Other adjustments	(144)	(5)	7
Income tax expense (benefit)	<u>\$ (16,925)</u>	<u>\$ 4,340</u>	<u>\$ 8,516</u>

The Company paid approximately \$112,000, \$95,000 and \$858,000 in income taxes for the years ended December 31, 2004, 2005 and 2006, respectively.

At December 31, 2006, the Company has net operating loss carryforwards for federal income tax purposes of approximately \$43.1 million, which expire, if unused, from the year 2013 through the year 2023. The Company has net operating loss carryforwards for U.K. income tax purposes of approximately \$4.7 million, which do not expire. The Company also has alternative minimum tax credit carryforwards of approximately \$820,000.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS ¾ (Continued)

8. COMMITMENTS AND CONTINGENCIES

The Company leases office facilities and office equipment under various noncancelable operating leases. The leases contain various renewal options. Rent expense for the years ended December 31, 2004, 2005 and 2006 was approximately \$6.1 million, \$6.8 million and \$7.0 million, respectively.

The Company entered into a sublease agreement during December 2006 that will terminate in March 2008. Future sublease income will total \$365,000 over the remaining term.

Future minimum lease payments as of December 31, 2006 are as follows (in thousands):

2007	\$	7,563
2008		6,871
2009		6,051
2010		3,378
2011		2,357
2012 and thereafter		2,414
	<u>\$</u>	<u>28,634</u>

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. The Company is not a party to any lawsuit or proceeding that, in the opinion of management, is likely to have a material adverse effect on its financial position or results of operations.

9. RESTRUCTURING CHARGES

Effective July 21, 2005, the Company closed its research center in Mason, Ohio (the "Mason Operations"). The closing of the Mason Operations resulted in a one-time pre-tax restructuring charge of approximately \$2.2 million recorded in the third quarter of 2005. The third quarter restructuring charge included amounts for wages, severance, occupancy and other costs. Below is a summary of the expense recorded and the activity related to restructuring. The estimates have been made based upon management's best estimate of amounts and timing of certain events included in the restructuring plan that will occur in the future. It is possible that the actual outcome of certain events may differ from estimates. Changes will be made to the restructuring accrual at the point that any such differences become determinable.

Restructuring expenses (in thousands):

	<u>Accrual balance as of December 31, 2005</u>	<u>2006 charges utilized</u>	<u>Accrual balance as of December 31, 2006</u>
Occupancy	\$ 973	\$ 439	\$ 534
Wages, severance, and other costs	64	64	0
Total restructuring charge	<u>\$ 1,037</u>	<u>\$ 503</u>	<u>\$ 534</u>

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

10. STOCKHOLDERS' EQUITY

Preferred Stock

The Company has 2,000,000 shares of preferred stock, \$0.01 par value, authorized for issuance. The Board of Directors may issue the preferred stock from time to time as shares of one or more classes or series.

Common Stock

The Company has 30,000,000 shares of common stock, \$0.01 par value, authorized for issuance. Dividends may be declared and paid on the common stock, subject in all cases to the rights and preferences of the holders of preferred stock and authorization by the Board of Directors. In the event of liquidation or winding up of the Company and after the payment of all preferential amounts required to be paid to the holders of any series of preferred stock, any remaining funds shall be distributed among the holders of the issued and outstanding common stock.

11. NET INCOME PER SHARE

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

	Year Ended December 31,		
	2004	2005	2006
Numerator:			
Net income	\$ 24,985	\$ 6,457	\$ 12,410
Denominator:			
Denominator for basic net income per share $\frac{3}{4}$ weighted-average outstanding shares	18,165	18,453	18,751
Effect of dilutive securities:			
Stock options and warrants	662	554	414
Denominator for diluted net income per share $\frac{3}{4}$ weighted-average outstanding shares	18,827	19,007	19,165
Net income per share $\frac{3}{4}$ basic	\$ 1.38	\$ 0.35	\$ 0.66
Net income per share $\frac{3}{4}$ diluted	\$ 1.33	\$ 0.34	\$ 0.65

Stock options and warrants to purchase approximately 1,188,000, 921,000 and 86,900 shares were outstanding as of December 31, 2004, 2005 and 2006, respectively, but were not included in the computation of diluted earnings per share because the exercise price of the stock options was greater than the average share price of the common shares and, therefore, the effect would have been anti-dilutive.

12. EMPLOYEE BENEFIT PLANS

Stock Incentive Plan

In June 1998 the Company's Board of Directors adopted the 1998 Stock Incentive Plan (the "1998 Plan") prior to consummation of the Company's initial public offering. The 1998 Plan provides for the grant of stock and stock options to officers, directors and employees of the Company and its subsidiaries. Stock options granted under the 1998 Plan may be incentive or non-qualified. The exercise price for an incentive stock option may not be less than the fair market value of the Company's common stock on the date of grant. The vesting period of the options and restricted stock grants is determined by the Board of Directors and is generally three to four years. Upon the occurrence of a Change of Control, as defined in the 1998 Plan, all outstanding unexercisable options and restricted stock grants under the 1998 Plan immediately become exercisable. The Company has reserved 3,750,000 shares of common stock for issuance under the 1998 Plan. Unless terminated sooner by the Board of Directors, the 1998 Plan will terminate in 2008. Approximately 440,000 and 181,000 shares were available for future grant under the 1998 Plan as of December 31, 2005 and 2006, respectively.

Option activity was as follows:

	Number of Shares	Range of Exercise Price	Weighted-Average Exercise Price	Weighted Average Remaining Contract Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2003	1,921,326	\$ 3.45 - \$52.13	\$ 22.72		
Granted	487,000	\$ 39.00 - \$45.18	\$ 41.67		
Exercised	(424,166)	\$ 3.45 - \$37.13	\$ 14.84		
Canceled or expired	(133,826)	\$ 16.13 - \$44.86	\$ 27.25		
Outstanding at December 31, 2004	1,850,334	\$ 9.00 - \$52.13	\$ 29.21		
Granted	10,000	\$ 43.17 - \$43.17	\$ 43.17		
Exercised	(292,474)	\$ 9.00 - \$44.86	\$ 25.34		
Canceled or expired	(93,963)	\$ 17.25 - \$45.18	\$ 33.68		
Outstanding at December 31, 2005	1,473,897	\$ 9.00 - \$52.13	\$ 29.76		
Granted	96,900	\$ 51.92	\$ 51.92		
Exercised	(269,755)	\$ 9.00 - \$45.18	\$ 24.35		
Canceled or expired	(26,565)	\$ 18.28 - \$45.18	\$ 37.85		
Outstanding at December 31, 2006	1,274,477	\$ 9.00 - \$52.13	\$ 32.23	5.69	\$ 27,186
Exercisable at December 31, 2004	886,494	\$ 9.00 - \$52.13	\$ 25.99		
Exercisable at December 31, 2005	960,454	\$ 9.00 - \$52.13	\$ 27.04		
Exercisable at December 31, 2006	929,324	\$ 9.00 - \$52.13	\$ 28.93	4.86	\$ 22,891

12. EMPLOYEE BENEFIT PLANS ³/₄ (Continued)

Stock Incentive Plan ³/₄ (Continued)

The aggregate intrinsic value is calculated as the difference between (i) the closing price of the common stock at December 31, 2004, 2005 and 2006, respectively and (ii) the exercise prices of the underlying awards, multiplied by 424,166, 292,474, and 269,755 options as of December 31, 2004, 2005 and 2006, respectively, that had an exercise price less than the closing price on that date. The aggregate intrinsic value of options exercised was \$5.5 million, \$5.9 million and \$7.4 million for the years ended December 31, 2004, 2005, and 2006 respectively, determined as of the date of option exercise.

At December 31, 2006, there was \$12.3 million of unrecognized compensation cost related to stock-based payments, net of forfeitures, which is expected to be recognized over a weighted-average-period of 2.5 years.

The weighted-average grant date fair value of each option granted during the years ended December 2004, 2005 and 2006 was \$28.90, \$26.65 and \$33.45 respectively.

The Company estimated the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, using the assumptions noted in the following table:

	2004	Year Ended December 31, 2005	2006
Dividend yield	0%	0%	0%
Expected volatility	67%	64%	61%
Risk-free interest rate	3.6%	4.4%	4.7%
Expected life (in years)	5	5	5

The assumptions above and the estimation of expected forfeitures are based on multiple facts, 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.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

12. EMPLOYEE BENEFIT PLANS $\frac{3}{4}$ (Continued)

Stock Incentive Plan $\frac{3}{4}$ (Continued)

The following table summarizes information regarding options outstanding at December 31, 2006:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
\$ 9.00 - \$18.06	144,247	4.13	\$ 15.95	136,247	\$ 15.84
\$ 18.12 - \$21.31	127,839	5.55	\$ 19.28	111,089	\$ 19.40
\$ 21.67 - \$28.15	189,518	5.49	\$ 26.16	166,018	\$ 25.91
\$ 29.00 - \$29.00	1,000	2.61	\$ 29.00	1,000	\$ 29.00
\$ 30.00 - \$30.00	180,000	2.25	\$ 30.00	180,000	\$ 30.00
\$ 30.06 - \$31.50	128,603	5.12	\$ 30.42	108,040	\$ 30.49
\$ 32.00 - \$39.53	166,745	6.84	\$ 38.97	89,743	\$ 38.80
\$ 39.81 - \$44.86	160,375	7.15	\$ 43.38	84,437	\$ 43.44
\$ 45.18 - \$51.92	175,150	8.83	\$ 48.55	51,750	\$ 45.27
\$ 52.13 - \$52.13	1,000	3.20	\$ 52.13	1,000	\$ 52.13
\$ 9.00 - \$52.13	<u>1,274,477</u>	5.69	\$ 32.23	<u>929,324</u>	\$ 28.93

The following table presents unvested restricted stock awards activity for the year ended December 31, 2006:

	Number of Shares	Weighted Average Grant Date
		Fair Value per Share
Unvested restricted stock at December 31, 2005	71,807	\$ 50.14
Granted	165,290	\$ 48.98
Vested	(17,601)	\$ 42.57
Canceled	(7,219)	\$ 44.93
Unvested restricted stock at December 31, 2006	<u>212,277</u>	\$ 47.46

Employee 401(k) Plan

The Company maintains a 401(k) Plan (the "401(k)") as a defined contribution retirement plan for all eligible employees. The 401(k) provides for tax-deferred contributions of employees' salaries, limited to a maximum annual amount as established by the Internal Revenue Service. The Company matched 100% in 2004, 2005 and 2006 of employee contributions up to a maximum of 6% of total compensation. Amounts contributed to the 401(k) by the Company to match employee contributions for the years ended December 31, 2004, 2005 and 2006 were approximately \$1.2 million, \$1.6 million and \$2.0 million, respectively. The Company paid administrative expenses in connection with the 401(k) plan of approximately \$20,000, \$18,000 and \$25,000 for the years ended December 31, 2004, 2005 and 2006 respectively.

12. EMPLOYEE BENEFIT PLANS $\frac{3}{4}$ (Continued)

Employee Pension Plan

The Company maintains a company personal pension plan for all eligible employees in the Company's London, England office. The plan is a defined contribution plan. Employees are eligible to contribute a portion of their salaries, subject to a maximum annual amount as established by the Inland Revenue. The Company contributes a match subject to the percentage of the employees' contribution. Amounts contributed to the plan by the Company to match employee contributions for the years ended December 31, 2004, 2005 and 2006 were approximately \$146,000, \$175,000 and \$193,000 respectively.

Employee Stock Purchase Plan

As of August 1, 2006 the Company introduced an Employee Stock Purchase Plan ("ESPP"), pursuant to which eligible employees participating in the plan authorize the Company to withhold from the employees' compensation and use the withheld amounts to purchase shares of the Company's common stock at 90% of the market price. Participating employees are able to purchase common stock under this plan during the offering period. The offering period begins the Saturday before each of the Company's regular pay dates and ends on each of the Company's regular pay dates. There are 95,489 shares available for purchase under the plan as of December 31, 2006 and approximately 4,000 shares of the Company's common stock were purchased during 2006.

13. SUBSEQUENT EVENTS

On February 16, 2007, CoStar Limited, a wholly owned U.K. subsidiary of CoStar, acquired all outstanding capital stock of Propex, a U.K. company, from the shareholders of Propex pursuant to a Stock Purchase Agreement in exchange for consideration of approximately £11,000,000 (approximately \$22.0 million), consisting of cash and 21,526 shares of CoStar common stock. The purchase price is subject to decrease based on Propex's net worth as of the closing date. Propex provides web-based commercial property information and operates an electronic platform that facilitates the exchange of investment property in the U.K. Its suite of electronic platforms and listing websites give users access to the U.K. commercial property investment and leasing markets. The purchase price will be principally allocated to various working capital accounts, database technology, customer base and goodwill. The acquired database technology and customer base will be amortized over their estimated useful lives. Goodwill will not be amortized, but is subject to annual impairment tests.

14. BUSINESS SEGMENTS

Due to the increased size, complexity, and funding requirements associated with the Company's international expansion in 2007, the Company began to manage the business geographically in two operating segments, with the primary areas of measurement and decision-making being the United States and International, which includes the U.K. and France. Presented below is segment information for comparison purposes. Management relies on an internal management reporting process that provides revenue and segment EBITDA, which is the Company's net income before interest, income taxes, depreciation and amortization. Management believes that segment EBITDA is an appropriate measure for evaluating the operational performance of the 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 income from operations or other measures of financial performance prepared in accordance with GAAP.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS $\frac{3}{4}$ (Continued)

14. BUSINESS SEGMENTS $\frac{3}{4}$ (Continued)

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

	2004	Fiscal Year Ended December 31, 2005	2006
Revenues			
United States	\$ 102,607	\$ 123,360	\$ 146,073
International	9,478	10,978	12,816
Total Revenues	<u>\$ 112,085</u>	<u>\$ 134,338</u>	<u>\$ 158,889</u>
EBITDA			
United States	\$ 20,159	\$ 19,372	\$ 26,205
International	(403)	(316)	(315)
Total EBITDA	<u>\$ 19,756</u>	<u>\$ 19,056</u>	<u>\$ 25,890</u>
Reconciliation of EBITDA to net income			
EBITDA	\$ 19,756	\$ 19,056	\$ 25,890
Purchase amortization in cost of revenues	(2,453)	(1,250)	(1,205)
Purchase amortization in operating expenses	(4,351)	(4,469)	(4,183)
Depreciation and other amortization	(6,206)	(5,995)	(6,421)
Interest income, net	1,314	3,455	6,845
Income tax expense, net	16,925	(4,340)	(8,516)
Net income	<u>\$ 24,985</u>	<u>\$ 6,457</u>	<u>\$ 12,410</u>

International EBITDA includes a corporate allocation of approximately \$1.0 million for the years ended December 31, 2006, 2005 and 2004. The corporate allocation represents costs allocated for services for United States employees involved in international management activities.

	Fiscal Year Ended December 31, 2005	2006
Property and equipment, net		
United States	\$ 14,203	\$ 16,907
International	941	1,500
Total property and equipment, net	<u>\$ 15,144</u>	<u>\$ 18,407</u>
Assets		
United States	\$ 246,547	\$ 271,179
International	25,285	33,718
Total segment assets	<u>\$ 271,832</u>	<u>\$ 304,897</u>
Reconciliation of segment assets to total assets		
Total segment assets	\$ 271,832	\$ 304,897
Investment in subsidiaries	(18,343)	(18,343)
Intercompany receivables	(5,430)	(11,117)
Total assets	<u>\$ 248,059</u>	<u>\$ 275,437</u>