

ZILLOW INC  
Form 10-Q  
November 04, 2011  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2011

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

Commission File Number: 001-35237

**ZILLOW, INC.**

(Exact name of registrant as specified in its charter)

Edgar Filing: ZILLOW INC - Form 10-Q

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**20-2000033**  
(I.R.S. Employer

Identification Number)

**1301 Second Avenue, Floor 31, Seattle, Washington**  
(Address of principal executive offices)

**98101**  
(Zip Code)

**(206) 470-7000**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of October 31, 2011, 18,032,314 shares of Class A common stock and 9,528,313 shares of Class B common stock were outstanding.

**Table of Contents**

**ZILLOW, INC.**

**Quarterly Report on Form 10-Q**

**For the Three Months Ended September 30, 2011**

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements (unaudited)</u>	2
<u>Condensed Balance Sheets</u>	2
<u>Condensed Statements of Operations</u>	3
<u>Condensed Statements of Cash Flows</u>	4
<u>Notes to Condensed Financial Statements</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	27
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	28
Item 1A. <u>Risk Factors</u>	29
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	39
Item 6. <u>Exhibits</u>	40
<u>Signatures</u>	41

**Table of Contents**

As used in this Quarterly Report on Form 10-Q, the terms the Company, we, us and our refer to Zillow, Inc., unless the context indicates otherwise.

**NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q, including the sections entitled Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors, contains forward-looking statements based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include all statements that are not historical facts and generally may be identified by terms such as believe, may, will, estimate, continue, anticipate, intend, could, would, project, plan, expect of these words or similar expressions.

These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Part II, Item 1A (Risk Factors) of this report. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the effect of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

You should not rely on forward-looking statements as predictions of future events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements will be achieved or occur. Moreover, except as required by law, neither we nor any other person assumes responsibility for the accuracy and completeness of the forward-looking statements, and we undertake no obligation to update publicly any forward-looking statements for any reason after the date of this report to conform these statements to actual results or to changes in our expectations.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****ZILLOW, INC.****CONDENSED BALANCE SHEETS****(in thousands, except share data, unaudited)**

	September 30, 2011	December 31, 2010
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 95,813	\$ 12,278
Short-term investments		1,499
Accounts receivable, net of allowance for doubtful accounts of \$549 and \$501 at September 30, 2011 and December 31, 2010, respectively	6,115	3,984
Prepaid expenses and other current assets	848	410
<b>Total current assets</b>	<b>102,776</b>	<b>18,171</b>
Property and equipment, net	8,252	4,929
Goodwill	1,140	
Intangible assets, net	1,714	888
Other assets	40	25
<b>Total assets</b>	<b>\$ 113,922</b>	<b>\$ 24,013</b>
<b>Liabilities and shareholders equity</b>		
Current liabilities:		
Accounts payable	\$ 3,734	\$ 750
Accrued expenses and other current liabilities	4,063	576
Accrued compensation and benefits	1,597	1,349
Deferred revenue	5,734	3,284
Deferred rent, current portion	27	271
<b>Total current liabilities</b>	<b>15,155</b>	<b>6,230</b>
Deferred rent, net of current portion	629	335
Other non-current liabilities	471	
Commitments and contingencies (Note 11)		
Shareholders equity:		
Convertible preferred stock, \$0.0001 par value; no shares and 70,000,000 shares authorized as of September 30, 2011 and December 31, 2010, respectively; no shares and 31,353,797 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively		4
Preferred stock, \$0.0001 par value; 30,000,000 and no shares authorized as of September 30, 2011 and December 31, 2010, respectively; no shares issued and outstanding as of September 30, 2011 and December 31, 2010		
Class A common stock, \$0.0001 par value; 600,000,000 and 200,000,000 shares authorized as of September 30, 2011 and December 31, 2010, respectively; 18,029,698 and 1,290,602 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively	2	
Class B common stock, \$0.0001 par value; 15,000,000 and 35,000,000 shares authorized as of September 30, 2011 and December 31, 2010, respectively; 9,528,313 shares issued and outstanding as of September 30, 2011 and December 31, 2010	1	1

## Edgar Filing: ZILLOW INC - Form 10-Q

Class C nonvoting common stock, \$0.0001 par value; no shares and 50,000,000 shares authorized as of September 30, 2011 and December 31, 2010, respectively; no shares and 2,305,980 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively

Additional paid-in capital	176,195	96,152
Accumulated other comprehensive loss	(78,531)	(78,709)
Total shareholders' equity	97,667	17,448
Total liabilities and shareholders' equity	\$ 113,922	\$ 24,013

See accompanying notes to condensed financial statements.

**Table of Contents****ZILLOW, INC.****CONDENSED STATEMENTS OF OPERATIONS**

(in thousands, except per share data, unaudited)

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Revenues	\$ 19,057	\$ 8,229	\$ 46,162	\$ 20,894
Costs and expenses:				
Cost of revenues (exclusive of amortization) (1)	3,084	1,263	7,614	3,647
Sales and marketing	7,035	4,060	18,150	10,925
Technology and development	3,849	2,528	10,148	7,940
General and administrative (2)	5,695	1,902	10,151	4,726
<b>Total costs and expenses</b>	<b>19,663</b>	<b>9,753</b>	<b>46,063</b>	<b>27,238</b>
Income (loss) from operations	(606)	(1,524)	99	(6,344)
Other income	36	14	79	56
Net income (loss)	\$ (570)	\$ (1,510)	\$ 178	\$ (6,288)
Net income (loss) attributable to common shareholders	\$ (570)	\$ (1,510)	\$ 178	\$ (6,288)
Net income (loss) per share attributable to common shareholders basic	\$ (0.02)	\$ (0.12)	\$ 0.01	\$ (0.50)
Net income (loss) per share attributable to common shareholders diluted	\$ (0.02)	\$ (0.12)	\$ 0.01	\$ (0.50)
Weighted-average shares outstanding basic	24,020	12,803	17,141	12,702
Weighted-average shares outstanding diluted	24,020	12,803	20,220	12,702

(1) Amortization of website development costs and intangible assets included in technology and development is as follows:

	\$ 1,461	\$ 1,030	\$ 3,918	\$ 3,107
--	----------	----------	----------	----------

(2) General and administrative includes a facility exit charge as follows:

	\$ 1,737	\$	\$ 1,737	\$
--	----------	----	----------	----

See accompanying notes to condensed financial statements.

**Table of Contents****ZILLOW, INC.****CONDENSED STATEMENTS OF CASH FLOWS****(in thousands, unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Operating activities</b>		
Net income (loss)	\$ 178	\$ (6,288)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	5,429	3,896
Facility exit charge	1,737	
Share-based compensation expense	1,291	1,309
Loss on disposal of property and equipment	18	149
Bad debt expense	385	151
Deferred rent	496	(198)
Accretion of bond discount	(2)	(3)
Changes in operating assets and liabilities:		
Accounts receivable	(2,516)	(1,383)
Prepaid expenses and other assets	(453)	(323)
Accounts payable	2,984	583
Accrued expenses	2,022	695
Deferred revenue	2,450	2,056
Net cash provided by operating activities	14,019	644
<b>Investing activities</b>		
Proceeds from maturities of short-term investments	75,249	12,652
Purchases of short-term investments	(73,750)	(6,926)
Purchases of property and equipment	(7,460)	(3,606)
Purchases of intangible assets	(1,005)	(530)
Acquisition, net of cash acquired	(1,000)	
Net cash provided by (used in) investing activities	(7,966)	1,590
<b>Financing activities</b>		
Proceeds from exercise of Class A common stock options	1,194	587
Proceeds from initial public offering, net of offering costs	70,788	
Proceeds from concurrent private placement	5,500	
Net cash provided by financing activities	77,482	587
Net increase in cash and cash equivalents during period	83,535	2,821
Cash and cash equivalents at beginning of period	12,278	4,439
Cash and cash equivalents at end of period	\$ 95,813	\$ 7,260
<b>Supplemental disclosures of cash flow information</b>		
Noncash transactions:		
Capitalized share-based compensation	\$ 358	\$ 324
Class A common stock issued in connection with an acquisition	\$ 910	\$
Write-off of fully depreciated property and equipment	\$ 2,133	\$

See accompanying notes to condensed financial statements.





---

**Table of Contents**

**ZILLOW, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1. Organization and Description of Business**

Zillow, Inc. was incorporated as a Washington corporation effective December 13, 2004. We operate a real estate information marketplace dedicated to providing vital information about homes, real estate listings and mortgages and enabling homeowners, buyers, sellers and renters to connect with real estate and mortgage professionals.

***Certain Significant Risks and Uncertainties***

We operate in a dynamic industry and, accordingly, can be affected by a variety of factors. For example, we believe that changes in any of the following areas could have a significant negative effect on us in terms of our future financial position, results of operations or cash flows: rates of revenue growth; engagement and usage of our products; scaling and adaptation of existing technology and network infrastructure; competition in our market; management of our growth; acquisitions and investments; qualified employees and key personnel; protection of our brand and intellectual property; changes in government regulation affecting our business; intellectual property infringement and other claims; protection of customers' information and privacy concerns; and security measures related to our websites, among other things.

**Note 2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying condensed financial statements have been prepared in conformity with accounting principles generally accepted in the United States ( GAAP ) and applicable rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Registration Statement on Form S-1 (File No. 333-173570), as filed with the SEC. The condensed balance sheet as of December 31, 2010, included herein, was derived from the audited financial statements as of that date.

The unaudited condensed interim financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly our financial position as of September 30, 2011, our results of operations for the three and nine month periods ended September 30, 2011 and 2010 and our cash flows for the nine months ended September 30, 2011 and 2010. The results of the three and nine month periods ended September 30, 2011 are not necessarily indicative of the results to be expected for the year ended December 31, 2011 or for any other interim period or for any other future year.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and the related disclosures at the date of the financial statements, as well as the reported amounts of revenues and expenses during the periods presented. Estimates are used for revenue recognition, the allowance for doubtful accounts, website development costs, recoverability of intangible assets with definite lives and other long-lived assets and for share-based compensation. To the extent there are material differences between these estimates, judgments, or assumptions and actual results, our financial statements will be affected.

***Reverse Stock Split***

On June 16, 2011, our board of directors and shareholders approved a 3.38-for-1 reverse stock split of our outstanding Class A common stock, Class B common stock and Class C common stock that was effected on June 17, 2011. The conversion prices at which shares of our convertible preferred stock were automatically converted were adjusted to reflect the reverse stock split. All references to Class A common stock, Class B common stock and Class C common stock in the condensed financial statements and the notes thereto, including but not limited to the number of

## Edgar Filing: ZILLOW INC - Form 10-Q

shares and per share amounts, unless otherwise noted, have been adjusted to reflect the reverse stock split retroactively. Previously awarded options to purchase shares of our Class A common stock have also been retroactively adjusted to reflect the reverse stock split.

### ***Reclassifications***

Certain reclassifications have been made to conform the prior periods data to the current format.

**Table of Contents****Recently Issued Accounting Standards**

In October 2009, the FASB issued guidance on revenue recognition to require companies to allocate revenue in multiple-element arrangements based on an element's estimated selling price if vendor-specific or other third-party evidence of value is not available. This guidance is effective beginning January 1, 2011 with earlier application permitted. We adopted this guidance prospectively starting on January 1, 2011. The adoption of this guidance did not and is not expected to have any impact on our financial position, results of operations, cash flows or disclosures based on the types of revenue arrangements we have historically entered into and currently have in place.

In September 2011, the FASB issued guidance on testing goodwill for impairment to permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. This guidance is effective for fiscal years beginning after December 15, 2011 with earlier application permitted. We will early adopt this guidance for our annual goodwill impairment test performed in our fourth quarter of 2011. The adoption of this guidance is not expected to have any impact on our financial position, results of operations or cash flows.

**Note 3. Fair Value Measurements**

Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. The standards also establish a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

There are three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Assets and liabilities valued based on observable market data for similar instruments, such as quoted prices for similar assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity; instruments valued based on the best available data, some of which is internally developed, and considers risk premiums that a market participant would require.

**Assets**

*Cash equivalents* Cash equivalents include money market funds and certificates of deposit with original maturities of three months or less. The fair value measurement of these assets is based on quoted market prices in active markets and, therefore, these assets are recorded at fair value on a recurring basis and classified as Level 1 in the fair value hierarchy.

*Short-term investments* Short-term investments consist of U.S. government agency securities. The fair value measurement of these assets is based on observable market-based Level 1 inputs or inputs that are derived principally from or corroborated by observable market data by correlation or other means and, therefore, is recorded at fair value on a recurring basis. There were no short-term investments outstanding as of September 30, 2011. The balance of short-term investments was \$1.5 million at December 31, 2010.

The following table presents the balances of assets measured at fair value on a recurring basis as of the dates presented (in thousands), all of which are classified as Level 1 in the fair value hierarchy:

	September 30, 2011	December 31, 2010
Assets:		
Cash equivalents:		
Money market funds	\$ 64,346	\$ 11,517
Certificates of deposit	30,000	
Short-term investments:		

Edgar Filing: ZILLOW INC - Form 10-Q

U.S. Treasury securities			1,499
Total	\$	94,346	\$ 13,016

We did not have any Level 2 or Level 3 assets measured at fair value on a recurring basis as of September 30, 2011 or December 31, 2010.

**Table of Contents****Note 4. Accounts Receivable, net**

The following table presents the detail of accounts receivable as of the dates presented (in thousands):

	September 30, 2011	December 31, 2010
Accounts receivable	\$ 6,664	\$ 4,485
Less: allowance for doubtful accounts	(549)	(501)
Accounts receivable, net	\$ 6,115	\$ 3,984

**Note 5. Property and Equipment, net**

The following table presents the detail of property and equipment as of the dates presented (in thousands):

	September 30, 2011	December 31, 2010
Computer equipment	\$ 9,027	\$ 8,072
Website development costs	22,277	18,921
Leasehold improvements	2,200	1,891
Software	1,299	1,153
Construction-in-progress	1,125	675
Office equipment, furniture and fixtures	960	511
Property and equipment	36,888	31,223
Less: accumulated amortization and depreciation	(28,636)	(26,294)
Property and equipment, net	\$ 8,252	\$ 4,929

We recorded amortization and depreciation expense related to property and equipment other than website development costs of \$0.6 million and \$0.3 million, respectively, during the three months ended September 30, 2011 and 2010, and \$1.5 million and \$0.8 million, respectively, during the nine months ended September 30, 2011 and 2010.

We capitalized \$1.3 million and \$0.9 million, respectively, in website development costs during the three months ended September 30, 2011 and 2010, and \$3.8 million and \$2.9 million, respectively, during the nine months ended September 30, 2011 and 2010. Amortization expense for website development costs included in technology and development expenses totaled \$1.1 million and \$0.9 million, respectively, during the three months ended September 30, 2011 and 2010, and \$3.0 million and \$2.6 million, respectively, during the nine months ended September 30, 2011 and 2010.

Construction-in-progress primarily consists of website development costs that are capitalizable, but for which the associated applications had not been placed in service.

**Note 6. Intangible Assets**

The following table presents the detail of intangible assets subject to amortization as of the dates presented (in thousands):

September 30, 2011	December 31, 2010
-----------------------	----------------------

## Edgar Filing: ZILLOW INC - Form 10-Q

Purchased content	\$ 5,189	\$ 4,184
Developed technology	630	
Customer relationships	80	
Trademarks	60	
<b>Intangible assets</b>	<b>5,959</b>	<b>4,184</b>
Less: accumulated amortization	(4,245)	(3,296)
<b>Intangible assets, net</b>	<b>\$ 1,714</b>	<b>\$ 888</b>

Amortization expense recorded for intangible assets for the three months ended September 30, 2011 and 2010 was \$0.4 million and \$0.1 million, respectively. Amortization expense recorded for intangible assets for the nine months ended September 30, 2011 and 2010 was \$0.9 million and \$0.5 million, respectively. These amounts are included in technology and development expenses.

---

**Table of Contents**

**Note 7. Income Taxes**

We are subject to federal income taxes in the United States. During the three and nine months ended September 30, 2011 and 2010, we did not have taxable income and, therefore, no tax liability or expense has been recorded in the financial statements. We have accumulated tax losses of approximately \$64.0 million as of December 31, 2010, which are available to reduce future taxable income.

**Note 8. Shareholders Equity**

Upon the effectiveness of the our registration statement on July 19, 2011, all of the outstanding shares of convertible preferred stock and all of the outstanding shares of Class C common stock automatically converted into 9,276,190 and 2,305,980 shares of Class A common stock, respectively.

On July 25, 2011, we closed our initial public offering ( IPO ) of 3,981,300 shares of Class A common stock at an offering price of \$20.00 per share, including 519,300 Class A common shares pursuant to the underwriters' option to purchase additional shares, and also closed the sale of 274,999 shares of our Class A common stock in a private placement at a price of \$20.00 per share, resulting in net proceeds to us of \$76.3 million after deducting underwriting discounts and commissions and net expenses paid in connection with the IPO.

***Common Stock***

Our Class A common stock has no preferences or privileges and is not redeemable. Holders of Class A common stock are entitled to one vote for each share.

Our Class B common stock has no preferences or privileges and is not redeemable. At any time after the date of issuance, each share of Class B common stock, at the option of the holder, shall be converted into one share of Class A common stock, or automatically converted upon the affirmative vote by or written consent of holders of a majority of the shares of the Class B common stock. Holders of Class B common stock are entitled to 10 votes for each share.

**Note 9. Share-Based Awards**

Upon execution of the underwriting agreement related to our IPO on July 19, 2011, the 2011 Incentive Plan (the 2011 Plan ) became effective. The 2011 Plan is administered by the compensation committee of the board of directors. Under the terms of the 2011 Plan, the compensation committee of the board of directors may grant stock awards, including incentive stock options or nonqualified stock options, to employees, officers, directors, consultants, agents, advisors and independent contractors. After the effective date of the 2011 Plan, all equity awards will be granted under the 2011 Plan rather than the Amended and Restated 2005 Equity Incentive Plan (the 2005 Plan ), which was the preexisting plan. On August 5, 2011, we filed a registration statement on Form S-8 under the Securities Act to register 6,816,135 shares of our Class A common stock for issuance under our 2005 Plan and 2011 Plan.

All stock options granted since inception under the 2005 Plan and the 2011 Plan have been nonqualified stock options. Options under the 2011 Plan are granted with an exercise price per share not less than 100% of the fair market value of our Class A common stock on the grant date, and are exercisable at such times and under such conditions as determined by the compensation committee of the board of directors. Under the 2011 Plan, the maximum term of an option is ten years from the date of grant. Any portion of an option that is not vested and exercisable on the date of a participant's termination of service shall expire on such date. Employees forfeit their rights to exercise vested options after 3 months or 12 months following the termination of their employment, depending on the cause of termination. Options granted to date under the 2011 Plan have been granted with a seven-year term and vest 25% after 12 months, and the remaining 75% of the award vests ratably over the next 36 months.



**Table of Contents**

A summary of stock option activity for the year ended December 31, 2010 and the nine months ended September 30, 2011 is as follows:

	Options Available for Grant	Number of Shares Subject to Existing Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2009	1,015,008	4,394,807	\$ 4.04		
Authorized increase in plan shares	1,109,467				
Granted	(1,440,227)	1,440,227	3.47		
Exercised		(487,401)	1.95		
Forfeited or cancelled	337,323	(337,323)	4.79		
Outstanding at December 31, 2010	1,021,571	5,010,310	4.03	4.48	\$ 3,843,806
Authorized increase in plan shares	1,477,514				
Granted	(1,479,181)	1,479,181	7.83		
Exercised		(693,521)	1.72		
Forfeited or cancelled	134,293	(134,293)	5.51		
Outstanding at September 30, 2011	1,154,197	5,661,677	5.27	4.90	125,724,755
Vested and exercisable at September 30, 2011		2,879,049	4.67	3.30	65,310,304

The fair value of options granted is estimated at the date of grant using the Black-Scholes-Merton option-pricing model, assuming no dividends and with the following assumptions for the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Expected volatility	50%	48%	50-52%	47%-53%
Expected dividend yields				
Risk-free interest rate	0.80%-1.15%	1.11%-1.41%	0.80%-2.00%	1.11%-2.31%
Weighted-average expected life	4.58 years	4.58 years	4.58 years	4.58 years
Weighted-average fair value of options granted	\$12.96	\$1.33	\$3.73	\$1.53

**Table of Contents**

The following table presents the effects of share-based compensation on our statements of operations during the periods presented (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of revenues	\$ 48	\$ 61	\$ 134	\$ 168
Sales and marketing	85	117	259	332
Technology and development	135	102	311	303
General and administrative	220	188	587	506
<b>Total</b>	<b>\$ 488</b>	<b>\$ 468</b>	<b>\$ 1,291</b>	<b>\$ 1,309</b>

As of September 30, 2011, there was a total of \$5.5 million in unrecognized compensation cost related to nonvested stock options, which is expected to be recognized over a remaining weighted-average period of 2.86 years.

**Note 10. Net Income (Loss) Per Share Attributable to Common Shareholders**

Basic net income (loss) per share is computed by dividing net income (loss) attributable to common shareholders by the weighted-average number of common shares (including Class A common stock, Class B common stock and Class C common stock) outstanding during the period. For the three and nine months ended September 30, 2010, no losses were allocated to Series A, B and C convertible preferred shareholders, as these shareholders did not have contractual obligations to share in or fund the losses of the Company. Thus, for the three and nine months ended September 30, 2010, the net loss is allocated entirely to the Class A common stock, Class B common stock and Class C common stock.

Diluted net income (loss) per share attributable to common shareholders is computed by dividing net income (loss) by the weighted-average number of common shares (including Class A common stock, Class B common stock and Class C common stock) outstanding during the period and potentially dilutive Class A common stock equivalents, except in cases where the effect of the Class A common stock equivalent would be antidilutive. The Class A common stock equivalents consist of Class A common stock issuable upon exercise of stock options using the treasury stock method, and for the three and nine months ended September 30, 2010, include Class A common stock issued upon the automatic conversion of our Series A, B and C convertible preferred stock on July 19, 2011.

For the three months ended September 30, 2011, 5,661,677 shares underlying stock options have been excluded from the calculations of diluted net income (loss) per share attributable to common shareholders because their effect would have been antidilutive. For the nine months ended September 30, 2011, 3,078,262 Class A common stock equivalents were included in the computation of diluted net income (loss) per share attributable to common shareholders because they had a dilutive impact.

For the three and nine months ended September 30, 2010, 5,411,277 shares underlying stock options and 9,276,190 shares of Class A common stock issued upon the automatic conversion of our convertible preferred stock on July 19, 2011 have been excluded from the calculations of diluted net income (loss) per share attributable to common shareholders because their effect would have been antidilutive.

In the event of liquidation, dissolution, distribution of assets or winding-up of the Company, the holders of all classes of common stock have equal rights to receive all the assets of the Company after the rights of the holders of the preferred stock have been satisfied. We have not presented net income (loss) per share attributable to common shareholders under the two-class method for our Class A common stock, Class B common stock and Class C common stock because it would be the same for each class due to equal dividend and liquidation rights for each class.

**Table of Contents****Note 11. Commitments and Contingencies*****Lease Commitments***

We have various operating leases for office space and equipment. We moved into our current headquarters in Seattle, Washington in August 2011 under an operating lease for which we will be obligated to make escalating monthly lease payments beginning in December 2012 and continuing through November 2022. The operating lease for our headquarters prior to August 2011 expires in February 2013. As a result of vacating the office space, we recorded a facility exit charge for \$1.7 million related to costs that will continue to be incurred under the operating lease for the remaining term. The \$1.7 million facility exit charge is included in general and administrative expenses in the condensed statements of operations for the three and nine months ended September 30, 2011. As of September 30, 2011, there was \$1.4 million of accrued facility exit costs included in accrued expenses and other current liabilities and \$0.5 million included in other non-current liabilities. Future minimum payments for all operating leases as of September 30, 2011 are as follows (in thousands):

2011	\$ 401
2012	1,733
2013	2,115
2014	1,845
2015	1,799
All future years	14,234
<b>Total future minimum lease payments</b>	<b>\$ 22,127</b>

Rent expense for the three months ended September 30, 2011 and 2010 was \$0.7 million and \$0.3 million, respectively. Rent expense for the nine months ended September 30, 2011 and 2010 was \$1.6 million and \$0.9 million, respectively.

***Purchase Commitments***

As of September 30, 2011, we have purchase commitments for data that is used to populate our websites totaling \$2.9 million. The amount due for this content is as follows (in thousands):

2011	\$ 322
2012	839
2013	520
2014	520
2015	520
All future years	130
<b>Total future purchase commitments</b>	<b>\$ 2,851</b>

***Line of Credit***

In March 2011, we entered into a loan and security agreement with a financial institution to establish a line of credit of \$4.0 million, secured by substantially all our assets other than our intellectual property, to be used for general business purposes. The line of credit contains financial and non-financial covenants. As of September 30, 2011, we were in compliance with all covenants. The line of credit is available through March 2013. In March 2011, we executed a standby letter of credit of \$1.5 million in connection with the lease of our new Seattle offices and reserved this amount against the line of credit, which reduces the available line to \$2.5 million.

***Legal Proceedings***

In October 2009, Mortgage Grader LLC filed a complaint against us for patent infringement in the Eastern District of Texas. The complaint alleged, among other things, that our website technology infringes one patent owned by Mortgage Grader, and sought injunctive relief, monetary

## Edgar Filing: ZILLOW INC - Form 10-Q

damages, costs and attorneys' fees. We denied Mortgage Grader's allegations and asserted counterclaims seeking declarations that we were not infringing the Mortgage Grader patent, and that the Mortgage Grader patent was unenforceable and invalid. In April 2010, Zillow and Mortgage Grader signed a patent license and settlement agreement for an insubstantial payment.

In May 2010, Source Search Technologies, LLC (SST) filed an action in the U.S. District Court, District of New Jersey alleging that we infringed certain patent rights. In March 2011, we signed a settlement agreement with SST, and Zillow paid a small one-time license fee. As a result of the settlement, effective from January 1, 2010 for as long as the related patent is valid and enforceable in the U.S., we must pay to SST insubstantial royalties on a quarterly basis under the terms of the agreement.

**Table of Contents**

In March 2010, Smarter Agent, LLC filed a complaint against us for patent infringement in the U.S. District Court for the District of Delaware. The complaint seeks, among other things, a judgment that we may have infringed certain patents held by Smarter Agent, an injunctive order against the alleged infringing activities and an award for damages. In November 2010, the U.S. Patent Office granted our petition for re-examination of the three patents-in-suit, and in an initial office action rejected all claims. In March 2011, the court granted a stay of the litigation pending the completion of the re-examination proceedings. We were granted a stay against the patent infringement complaint. We have not recorded an accrual related to this complaint as of September 30, 2011 or December 31, 2010 as we do not believe a material loss is probable. It is a reasonable possibility that a loss may be incurred; however, the possible loss or range of loss is not estimable.

In April 2010, First American CoreLogic filed a complaint against us, for patent infringement in the U.S. District Court for the Eastern District of Texas. The complaint seeks, among other things, a judgment that we may have infringed certain patents held by CoreLogic, an injunctive order against the alleged infringing activities and an award for damages. We have not recorded an accrual related to this complaint as of September 30, 2011 or December 31, 2010 as we do not believe a material loss is probable. It is a reasonable possibility that a loss may be incurred; however, the possible loss or range of loss is not estimable.

In September 2010, LendingTree, LLC filed a complaint against us, for patent infringement in the U.S. District Court for the Western District of North Carolina. The complaint seeks, among other things, a judgment that we may have infringed certain patents held by LendingTree, an injunctive order against the alleged infringing activities and an award for damages. We have not recorded an accrual related to this complaint as of September 30, 2011 or December 31, 2010 as we do not believe a material loss is probable. It is a reasonable possibility that a loss may be incurred; however, the possible loss or range of loss is not estimable.

In July 2011, Traffic Information, LLC filed a complaint against us, and other defendants, for patent infringement in the U.S. District Court for the Eastern District of Texas, Marshall Division. The complaint alleges, among other things, that we may have infringed a patent held by Traffic Information, LLC, related to delivering traffic information to mobile devices. The complaint does not specify how we are allegedly infringing, but seeks injunctive relief and unspecified damages. We intend to vigorously defend the claims. We have not recorded an accrual related to this complaint as of September 30, 2011 as we do not believe a material loss is probable. It is a reasonable possibility that a loss may be incurred; however, the possible loss or range of loss is not estimable.

In September 2011, I2Z Technology, LLC filed a complaint against us, and other defendants, for patent infringement in the U.S. District Court for the District of Oregon, Portland Division. The complaint alleges, among other things, that we may have infringed a patent held by I2Z Technology, LLC, related to the synchronization of simultaneous displays of related data sources. The complaint seeks injunctive relief and unspecified damages. We intend to vigorously defend the claims. We have not recorded an accrual related to this complaint as of September 30, 2011 as we do not believe a material loss is probable. It is a reasonable possibility that a loss may be incurred; however, the possible loss or range of loss is not estimable.

In addition to the aforementioned, from time to time, we are involved in litigation and claims that arise in the ordinary course of business. Although we cannot be certain of the outcome of any litigation and claims, nor the amount of damages and exposure that we could incur, we currently believe that the final disposition of such matters will not have a material effect on our financial position, results of operations or cash flow. Regardless of the outcome, litigation can have an adverse impact on us because of defense and settlement costs, diversion of management resources and other factors.

**Note 12. Segment Information and Revenues**

We have one reportable segment. Our reportable segment has been identified based on how our chief operating decision-maker manages our business, makes operating decisions and evaluates operating performance. The chief executive officer acts as the chief operating decision-maker and reviews financial and operational information on an entity-wide basis. We have one business activity and there are no segment managers who are held accountable for operations, operating results or plans for levels or components. Accordingly, we have determined that we have a single reporting segment and operating unit structure.

The chief executive officer reviews information about revenue categories for purposes of allocating resources and evaluating financial performance. The following table presents our revenue categories during the periods presented (in thousands):

Three Months Ended		Nine Months Ended	
September 30,		September 30,	
2011	2010	2011	2010

Edgar Filing: ZILLOW INC - Form 10-Q

Marketplace revenues	\$ 11,840	\$ 3,628	\$ 28,443	\$ 8,114
Display revenues	7,217	4,601	17,719	12,780
<b>Total</b>	<b>\$ 19,057</b>	<b>\$ 8,229</b>	<b>\$ 46,162</b>	<b>\$ 20,894</b>

**Table of Contents**

**Note 13. Subsequent Events**

On October 31, 2011, Zillow, Diverse Solutions, Inc. ( "Diverse Solutions" ), a California corporation, and Justin LaJoie, the controlling shareholder of Diverse Solutions, entered into an Asset Purchase Agreement (the "Purchase Agreement" ), pursuant to which Zillow acquired substantially all of the operating assets, including intellectual property rights and intangible assets, of Diverse Solutions. In consideration for the acquisition of the operating assets of Diverse Solutions under the terms of the Purchase Agreement, Zillow assumed certain operating liabilities, paid Diverse Solutions \$5,540,000 in cash and issued to Diverse Solutions 75,000 restricted shares of Zillow's Class A common stock (the "Restricted Shares" ). The Restricted Shares are subject to the terms and conditions of a Restricted Stock Agreement which became effective on October 31, 2011. The grant date fair value of the Restricted Shares is \$2,226,750. One-third of the Restricted Shares will vest and no longer be subject to forfeiture on the first anniversary of the vesting commencement date, which is October 31, 2011, subject to Justin LaJoie's continued employment or service to Zillow until such date. The remaining shares will vest ratably over the twenty-four months following such first anniversary, subject to Justin LaJoie's continued employment or service to Zillow. In the event of Justin LaJoie's termination of service by Zillow without cause or by Justin LaJoie for good reason, any unvested shares on the date of such termination will become vested and no longer subject to forfeiture.

---

## **Table of Contents**

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

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. In addition to historical financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Statements containing words such as may, believe, anticipate, expect, intend, plan, project, projections, business outlook, estimate, or similar expressions constitute forward-looking statements. Our actual results may differ materially from those contained in or implied by any forward-looking statements. Factors that could cause or contribute to these differences include those discussed below and elsewhere in this Quarterly Report on Form 10-Q, particularly in Risk Factors.*

#### **Overview**

We are the leading real estate information marketplace. We provide vital information about homes, real estate listings and mortgages through our websites and mobile applications, enabling homeowners, buyers, sellers and renters to connect with real estate and mortgage professionals best suited to meet their needs. We are transforming the way consumers make home-related decisions.

Our living database of more than 100 million U.S. homes – homes for sale, homes for rent and homes not currently on the market – attracts an active and vibrant community of users. Individuals and businesses that use Zillow have updated information on more than 25 million homes and added approximately 65 million home photos, creating exclusive home profiles available nowhere else. These profiles include rich detailed information about homes, including property facts, listing information and purchase and sale data. We provide this information to our users where, when and how they want it, both through our websites and through our industry-leading mobile applications that enable consumers to access our information when they are curbside, viewing homes. Using industry-leading automated valuation models, we provide current home value estimates, or Zestimates, and current rental price estimates, or Rent Zestimates, on approximately 100 million U.S. homes. Our products and services present residential real estate data in novel ways that have revolutionized the way consumers search for, find and understand home-related information and make real estate decisions.

We generate revenues from local real estate professionals, primarily on an individual subscription basis, and from mortgage professionals and brand advertisers. Our revenues include marketplace revenues, consisting of subscriptions sold to real estate agents and advertising sold on a cost per click, or CPC, basis to mortgage lenders, and display revenues consisting of advertising placements sold primarily on a cost per thousand impressions, or CPM, basis.

During the three months ended September 30, 2011, we generated revenues of \$19.1 million, as compared to \$8.2 million in the three months ended September 30, 2010, an increase of 132%. The increase in revenues is primarily attributable to the increase in our marketplace revenues, which increased \$8.2 million, or 226%, to \$11.8 million during the three months ended September 30, 2011 from \$3.6 million during the three months ended September 30, 2010, as a result of growth in our Premier Agent program. There was a 131% increase in our Premier Agent Subscribers to 14,876 as of September 30, 2011 from 6,448 as of September 30, 2010. We also experienced significant growth in traffic to our websites and mobile applications. There were approximately 24.2 million average monthly unique users of our websites and mobile applications for the three months ended September 30, 2011 compared to 12.1 million average monthly unique users for the three months ended September 30, 2010, representing year-over-year growth of 101%.

We moved into our current headquarters in Seattle, Washington in August 2011. The operating lease for our headquarters prior to August 2011 expires in February 2013. As a result of vacating the office space, we recorded a facility exit charge for \$1.7 million related to costs that will continue to be incurred under the operating lease for the remaining term. As of September 30, 2011, we had 268 full-time employees, compared to 216 full-time employees as of December 31, 2010, an increase of 24%.

#### **Key Growth Drivers**

To analyze our business performance, determine financial forecasts and help develop long-term strategic plans, we frequently review the following key growth drivers:

##### *Unique Users*

Measuring unique users is important to us because our marketplace revenues depend in part on our ability to enable our users to connect with real estate and mortgage professionals, and our display revenues depend in part on the number of impressions delivered. Furthermore, our community of users improves the quality of our living database of homes with their contributions. We measure unique users with Omniture analytical tools. Zillow counts a unique user the first time an individual accesses either Zillow.com or Postlets.com using a web browser during a calendar month, and the first time an individual accesses Zillow's mobile applications using a mobile device during a calendar month. If an



## Edgar Filing: ZILLOW INC - Form 10-Q

individual accesses Zillow's websites using different web browsers within a given month, the first access by each such web browser is counted as a separate unique user. If an individual accesses both Zillow.com and Postlets.com in a single month, the first access to each website is counted as a separate unique user since unique users are tracked separately for each domain. If an individual accesses Zillow's mobile applications using different mobile devices within a given month, the first instance of access by each such mobile device is counted as a separate unique user.

**Table of Contents**

	Average Monthly Unique Users for the Three Months Ended September 30,		2010 to 2011 % Change
	2011	2010	
Unique Users	24,238	12,061	101%

*Premier Agent Subscribers*

The number of Premier Agent subscribers is an important driver of revenue growth because each subscribing agent pays us a monthly fee to participate in the program. We define a Premier Agent subscriber as an agent with a paid subscription at the end of a period.

	At September 30,		2010 to 2011 % Change
	2011	2010	
Premier Agent Subscribers	14,876	6,448	131%

**Basis of Presentation**

**Revenues**

We generate revenues from the sale of advertising services to businesses and professionals primarily associated with the real estate and mortgage industries. These professionals include local real estate professionals, primarily on an individual subscription basis, and mortgage professionals and brand advertisers. Our revenues include marketplace revenues and display revenues.

**Marketplace Revenues.** Marketplace revenues consist of subscriptions sold to real estate agents under our Premier Agent program and CPC advertising related to our Zillow Mortgage Marketplace sold to mortgage lenders and financial institutions.

Our Premier Agent program allows local real estate agents to establish a persistent online and mobile presence on Zillow in the zip codes they serve. We present contact information for each Premier Agent alongside home profiles and home listings within the agent's zip code, assisting consumers in evaluating and selecting the real estate agent best suited for them. Pricing for our Premier Agent subscriptions varies by zip code. Subscription advertising revenues are recognized on a straight-line basis during the contractual period over which the advertising is delivered. Typical terms of our Premier Agent subscription contracts are six months. Growth in our subscription advertising product is based on our ability to continue to attract agent subscribers and drive consumer traffic to those agents on our websites and through our mobile applications.

In Zillow Mortgage Marketplace, participating qualified mortgage lenders make a prepayment to gain access to consumers interested in connecting with mortgage professionals. Consumers who request rates for mortgage loans in Zillow Mortgage Marketplace are presented with personalized lender quotes from participating lenders. We only charge mortgage lenders a fee when users click on their links for more information regarding a mortgage loan quote. Mortgage lenders who exhaust their initial prepayment can then prepay additional funds to continue to participate in the marketplace.

**Display Revenues.** Display revenues primarily consist of graphical web and mobile advertising sold on a CPM basis to advertisers primarily in the real estate industry, including real estate brokerages, home builders, mortgage lenders and home services providers. Our advertising customers also include telecommunications, automotive, insurance and consumer products companies. We recognize these revenues as impressions are delivered to users interacting with our websites or mobile applications. Growth in display revenues depends on continuing growth in traffic to our websites and mobile applications, migration of advertising spend online from traditional broadcast and print media and our development of new advertising products.

**Costs and Expenses**

**Cost of Revenues.** Our cost of revenues consists of expenses related to operating our websites and mobile applications, including associated headcount expenses, such as salaries and benefits and share-based compensation and bonuses. Cost of revenues also includes credit card fees, ad serving costs paid to third parties, revenue-sharing costs related to our commercial business relationships and facilities costs allocated on a headcount basis.

**Sales and Marketing.** Sales and marketing expenses consist of headcount expenses, including salaries, commissions, benefits, share-based compensation expense and bonuses for sales, sales support, customer support, marketing and public relations employees. Sales and marketing

## Edgar Filing: ZILLOW INC - Form 10-Q

expenses also include other sales expenses related to promotional and marketing activities and facilities costs allocated on a headcount basis.

***Technology and Development.*** Technology and development expenses consist of headcount expenses, including salaries and benefits, share-based compensation expense and bonuses for salaried employees and contractors engaged in the design, development and testing of our websites. Technology and development expenses also include equipment and maintenance costs and facilities costs allocated on a headcount basis. Technology and development expenses also include amortization costs related to capitalized website and development activities and amortization of certain intangibles and other data agreement costs related to the purchase of data used to populate our websites.

**Table of Contents**

**General and Administrative.** General and administrative expenses consist of headcount expenses, including salaries, benefits, share-based compensation expense and bonuses for executive, finance, accounting, legal, human resources, recruiting and administrative support. General and administrative expenses also include legal, accounting and other third-party professional service fees, bad debt and facilities costs allocated on a headcount basis.

**Other Income.** Other income consists of interest income earned on our cash and cash equivalents and short-term investments.

**Income Taxes**

We are subject to U.S. federal income taxes. As of December 31, 2010 we did not have taxable income, and as of September 30, 2011, we do not have any projected taxable income and, therefore, no tax liability or expense has been recorded in the financial statements. We have provided a full valuation allowance against our net deferred tax assets as of December 31, 2010 and September 30, 2011, because there is significant uncertainty around our ability to realize the deferred tax assets in the future. We have accumulated tax losses of approximately \$64.0 million as of December 31, 2010, which are available to reduce current future taxable income.

**Results of Operations**

The following tables present our results of operations for the periods indicated and as a percentage of total revenues.

	Three Months Ended		Nine Months Ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
<b>Statements of Operations Data:</b>				
Revenues	\$ 19,057	\$ 8,229	\$ 46,162	\$ 20,894
Costs and expenses:				
Cost of revenues (exclusive of amortization) (1) (2)	3,084	1,263	7,614	3,647
Sales and marketing (1)	7,035	4,060	18,150	10,925
Technology and development (1)	3,849	2,528	10,148	7,940
General and administrative (1) (3)	5,695	1,902	10,151	4,726
Total costs and expenses	19,663	9,753	46,063	27,238
Income (loss) from operations	(606)	(1,524)	99	(6,344)
Other income	36	14	79	56
Net income (loss)	\$ (570)	\$ (1,510)	\$ 178	\$ (6,288)
Net income (loss) attributable to common shareholders	\$ (570)	\$ (1,510)	\$ 178	\$ (6,228)
Net income (loss) per share attributable to common shareholders basic	\$ (0.02)	\$ (0.12)	\$ 0.01	\$ (0.50)
Net income (loss) per share attributable to common shareholders diluted	\$ (0.02)	\$ (0.12)	\$ 0.01	\$ (0.50)
Weighted-average shares outstanding basic	24,020	12,803	17,141	12,702
Weighted-average shares outstanding diluted	24,020	12,803	20,220	12,702
<b>Other Financial Data:</b>				
Adjusted EBITDA (4)	\$ 3,654	\$ 246	\$ 8,556	\$ (1,139)

**Table of Contents**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(in thousands, unaudited)			
(1) Includes share-based compensation as follows:				
Cost of revenues	\$ 48	\$ 61	\$ 134	\$ 168
Sales and marketing	85	117	259	332
Technology and development	135	102	311	303
General and administrative	220	188	587	506
Total	\$ 488	\$ 468	\$ 1,291	\$ 1,309

(2) Amortization of website development costs and intangible assets included in technology and development is as follows:				
	\$ 1,461	\$ 1,030	\$ 3,918	\$ 3,107
(3) General and administrative includes a facility exit charge as follows:				
	\$ 1,737	\$	\$ 1,737	\$

(4) See Adjusted EBITDA below for more information and for a reconciliation of Adjusted EBITDA to net income (loss), the most directly comparable financial measure calculated and presented in accordance with U.S. generally accepted accounting principles, or GAAP.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(unaudited)			
<b>Percentage of Revenues:</b>				
Revenues	100%	100%	100%	100%
Costs and expenses:				
Cost of revenues (exclusive of amortization)	16	15	16	17
Sales and marketing	37	49	39	52
Technology and development	20	31	22	38
General and administrative	30	23	22	23
Total costs and expenses	103	119	100	130
Income (loss) from operations	(3)	(19)	0	(30)
Other income	0	0	0	0
Net income (loss)	(3%)	(18%)	0%	(30%)

**Adjusted EBITDA**

To provide investors with additional information regarding our financial results, we have disclosed Adjusted EBITDA within this Quarterly Report on Form 10-Q, a non-GAAP financial measure. We have provided a reconciliation below of Adjusted EBITDA to net income (loss), the most directly comparable GAAP financial measure.

We have included Adjusted EBITDA in this Quarterly Report on Form 10-Q because it is a key metric used by our management and board of directors to measure operating performance and trends and to prepare and approve our annual budget. In particular, the exclusion of certain expenses in calculating Adjusted EBITDA facilitates operating performance comparisons on a period-to-period basis.

Our use of Adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

## Edgar Filing: ZILLOW INC - Form 10-Q

Adjusted EBITDA does not reflect our cash expenditures or future requirements for capital expenditures or contractual commitments;

Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

Adjusted EBITDA does not consider the potentially dilutive impact of share-based compensation;

**Table of Contents**

Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and Adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements; and

Other companies, including companies in our own industry, may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Adjusted EBITDA does not reflect certain facility exit charges.

Because of these limitations, you should consider Adjusted EBITDA alongside other financial performance measures, including various cash flow metrics, net loss and our other GAAP results.

The following table presents a reconciliation of Adjusted EBITDA to net income (loss) for each of the periods presented.

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	2010	2010	2010	2010
	(in thousands, unaudited)			
<b>Reconciliation of Adjusted EBITDA to Net Income (Loss):</b>				
Net income (loss)	\$ (570)	\$ (1,510)	\$ 178	\$ (6,288)
Income tax expense (benefit)				
Other income	(36)	(14)	(79)	(56)
Depreciation and amortization expense	2,035	1,302	5,429	3,896
Share-based compensation expense	488	468	1,291	1,309
Facility exit charge	1,737		1,737	
Adjusted EBITDA	\$ 3,654	\$ 246	\$ 8,556	\$ (1,139)

**Three Months Ended September 30, 2011 and 2010****Revenues**

	Three Months Ended September 30, 2011		2010 to 2011 % Change
	2010	2010	
	(in thousands, unaudited)		
<b>Revenues:</b>			
Marketplace revenues	\$ 11,840	\$ 3,628	226%
Display revenues	7,217	4,601	57%
Total	\$ 19,057	\$ 8,229	132%

	Three Months Ended September 30, 2011	
	2011	2010
<b>Percentage of Revenues:</b>		
Marketplace revenues	62%	44%
Display revenues	38%	56%

## Edgar Filing: ZILLOW INC - Form 10-Q

Total

100%

100%

Overall revenues increased by \$10.8 million, or 132%, for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Marketplace revenues increased by 226%, and display revenues increased by 57%.

Marketplace revenues grew to \$11.8 million for the three months ended September 30, 2011, from \$3.6 million for the three months ended September 30, 2010, an increase of \$8.2 million. Marketplace revenues represented 62% of total revenues for the three months ended September 30, 2011 compared to 44% of total revenues for the three months ended September 30, 2010. The increase in marketplace revenues was primarily attributable to growth in the number of subscribers in our Premier Agent program to 14,876 as of September 30, 2011 from 6,448 as of September 30, 2010, representing growth of 131%, and was also the result of existing Premier Agent subscribers purchasing additional inventory.

Display revenues increased to \$7.2 million for the three months ended September 30, 2011, from \$4.6 million for the three months ended September 30, 2010, primarily as a result of increased interest in our advertising platform from endemic advertisers including builders, real estate brokers and lending institutions. Display revenues were also positively impacted by an increase in our unique users, which grew to 24.2 million average monthly unique users for the three months ended September 30, 2011 from 12.1 million average monthly unique users for the three months ended September 30, 2010, representing year-over-year growth of 101%.



**Table of Contents****Cost of Revenues**

	<b>Three Months Ended September 30,</b>		<b>2010 to 2011</b>
	<b>2011</b>	<b>2010</b>	<b>% Change</b>
	<b>(in thousands, unaudited)</b>		
Cost of revenues	\$ 3,084	\$ 1,263	144%

Cost of revenues increased by \$1.8 million, or 144%, for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. The increase in cost of revenues is primarily attributable to revenue sharing costs related to the strategic relationship with Yahoo! Real Estate, which launched in February 2011, as well as increases in credit card fees and other costs related to revenue growth, primarily in our marketplace revenues category.

We expect that our cost of revenues will increase in total in future years as we continue to incur more expenses associated with growth in revenues.

**Sales and Marketing**

	<b>Three Months Ended September 30,</b>		<b>2010 to 2011</b>
	<b>2011</b>	<b>2010</b>	<b>% Change</b>
	<b>(in thousands, unaudited)</b>		
Sales and marketing	\$ 7,035	\$ 4,060	73%

Sales and marketing expenses increased by \$3.0 million, or 73%, for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Approximately \$1.6 million of the increase is the result of advertising costs, tradeshow and related travel expenses incurred to promote our brand. There was also an increase in headcount expenses of \$1.0 million, primarily related to increases in the size of our sales team to promote our marketplace business. The remaining increase of \$0.4 million is primarily the result of consulting costs and additional depreciation expense.

We expect our sales and marketing expenses will increase in future years as we continue to invest more resources in growing our sales team and invest in marketing and advertising. Although these expenses may increase as a percentage of revenues in the near term, we expect these expenses will decrease as a percentage of revenues in the long term.

**Technology and Development**

	<b>Three Months Ended September 30,</b>		<b>2010 to 2011</b>
	<b>2011</b>	<b>2010</b>	<b>% Change</b>
	<b>(in thousands, unaudited)</b>		
Technology and development	\$ 3,849	\$ 2,528	52%

Technology and development expenses, which include research and development costs, increased by \$1.3 million, or 52%, for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Approximately \$0.5 million of the increase is the result of growth in headcount expenses. We also recorded an additional \$0.6 million in depreciation and amortization expense during the three months ended September 30, 2011.

Amortization expense included in technology and development expenses for website development costs and intangible assets was \$1.5 million and \$1.0 million, respectively, for the three months ended September 30, 2011 and 2010.

While we expect our technology and development expenses to increase in the future as we invest in new website and mobile functionality, we expect these expenses will decrease as a percentage of revenue.



**Table of Contents****General and Administrative**

	<b>Three Months Ended September 30,</b>		<b>2010 to 2011</b>
	<b>2011</b>	<b>2010</b>	<b>% Change</b>
	<b>(in thousands, unaudited)</b>		
General and administrative	\$ 5,695	\$ 1,902	199%

General and administrative expenses increased by \$3.8 million, or 199%, for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. Approximately \$1.7 million of the increase is a result of a facility exit charge we recorded during the three months ended September 30, 2011. In August 2011, we relocated our headquarters in Seattle, Washington to accommodate growth in our business. The fluctuation in general and administrative expenses was also driven by an increase of \$0.5 million in headcount-related costs driven by growth in headcount, an increase of \$0.6 million in professional services and consulting fees, an increase of \$0.6 million in rent and utilities expense, primarily related to rent and utilities expense recorded for our new corporate headquarters in Seattle, Washington, and a \$0.4 million increase in other miscellaneous expenses.

We expect our general and administrative expenses to increase in the near term as we invest in headcount expenses and expenses associated with being a public company, but expect these costs to remain flat or decline as a percentage of revenues over the long term.

**Nine Months Ended September 30, 2011 and 2010****Revenues**

	<b>Nine Months Ended September 30,</b>		<b>2010 to 2011</b>
	<b>2011</b>	<b>2010</b>	<b>% Change</b>
	<b>(in thousands, unaudited)</b>		
<b>Revenues:</b>			
Marketplace revenues	\$ 28,443	\$ 8,114	251%
Display revenues	17,719	12,780	39%
Total	\$ 46,162	\$ 20,894	121%

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
<b>Percentage of Revenues:</b>		
Marketplace revenues	62%	39%
Display revenues	38%	61%
Total	100%	100%

Overall revenues increased by \$25.3 million, or 121%, for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. Marketplace revenues increased by 251% and display revenues increased by 39%.

Marketplace revenues grew to \$28.4 million for the nine months ended September 30, 2011 from \$8.1 million for the nine months ended September 30, 2010. Marketplace revenues represented 62% of total revenues for the nine months ended September 30, 2011 compared to 39% of total revenues for the nine months ended September 30, 2010. The increase in marketplace revenues was primarily attributable to growth in our Premier Agent program, which resulted from growth in the number of subscribers in our Premier Agent program to 14,876 as of September 30, 2011 from 6,448 as of September 30, 2010, representing growth of 131%, and was also the result of existing Premier Agent subscribers purchasing additional inventory.



**Table of Contents**

Display revenues increased to \$17.7 million for the nine months ended September 30, 2011, from \$12.8 million for the nine months ended September 30, 2010, primarily as a result of an increase in our unique users, which grew to 24.2 million average monthly unique users for the three months ended September 30, 2011 from 12.1 million average monthly unique users for the three months ended September 30, 2010, representing year-over-year growth of 101%. The growth in unique users increased the number of graphical display impressions available for sale and advertiser demand for graphical display inventory.

**Cost of Revenues**

	Nine Months Ended September 30,		2010 to 2011
	2011	2010	% Change
	(in thousands, unaudited)		
Cost of revenues	\$ 7,614	\$ 3,647	109%

Cost of revenues increased by \$4.0 million, or 109%, for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. The increase in cost of revenues is primarily attributable to revenue sharing costs related to the strategic relationship with Yahoo! Real Estate, which launched in February 2011, as well as increases in credit card fees and other costs related to revenue growth, primarily in our marketplace revenues category.

**Sales and Marketing**

	Nine Months Ended September 30,		2010 to 2011
	2011	2010	% Change
	(in thousands, unaudited)		
Sales and marketing	\$ 18,150	\$ 10,925	66%

Sales and marketing expenses increased by \$7.2 million, or 66%, for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. The increase is primarily related to growth in headcount-related costs of \$4.0 million, primarily related to increases in the size of our sales team to promote our marketplace business, and increases in advertising, tradeshow, conferences and related travel expenses of \$2.4 million. The remaining increase of \$0.8 million is primarily the result of additional depreciation expense recorded and consulting costs.

**Technology and Development**

	Nine Months Ended September 30,		2010 to 2011
	2011	2010	% Change
	(in thousands, unaudited)		
Technology and development	\$ 10,148	\$ 7,940	28%

Technology and development expenses, which include research and development costs, increased by \$2.2 million, or 28%, for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. Approximately \$1.1 million of the increase is the result of amortization of intangible assets, including website development costs, purchased content and intangible assets acquired in our March 2011 acquisition of a real estate agent and rental property manager marketing service company. The remaining increase is primarily the result of growth in headcount-related costs of \$0.8 million and increases in various other miscellaneous expenses.

Amortization expense included in technology and development expenses for website development costs and intangible assets was \$3.9 million and \$3.1 million, respectively, for the nine months ended September 30, 2011 and 2010.

**General and Administrative**

Edgar Filing: ZILLOW INC - Form 10-Q

	Nine Months Ended September 30,		2010 to 2011 % Change
	2011	2010	
	(in thousands, unaudited)		
General and administrative	\$ 10,151	\$ 4,726	115%

**Table of Contents**

General and administrative expenses increased by \$5.4 million, or 115%, for the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010. Approximately \$1.7 million of the increase is a result of a facility exit charge we recorded during the nine months ended September 30, 2011. In August 2011 we relocated our headquarters in Seattle, Washington to accommodate growth in our business. The fluctuation in general and administrative expenses was also driven by an increase of \$1.2 million in headcount-related costs driven by growth in headcount, an increase of \$1.4 million in professional services and consulting fees, an increase of \$1.0 million in rent and utilities expense primarily related to rent and utilities expense recorded for our new corporate headquarters in Seattle, Washington, a \$0.2 million increase in travel costs, a \$0.2 million increase in bad debt expense and a \$0.4 million increase in various other miscellaneous expenses. The increases were partially offset by a \$0.7 million decrease in local, business and occupational and gross receipts taxes, approximately \$0.3 million of which was the result of a tax credit we received relating to a refund of certain state and local taxes from 2006 to 2009.

**Liquidity and Capital Resources**

Prior to our IPO, we funded our operations since inception primarily from the issuance of common and preferred stock, and for the nine months ended September 30, 2011 from cash generated from operations. Through 2007, we raised approximately \$81.0 million through various offerings of our convertible preferred stock and approximately \$5.9 million from the sale of our common stock.

On July 25, 2011, we sold and issued 3,981,300 shares of our Class A common stock, including 519,300 shares of Class A common stock pursuant to the underwriters' option to purchase additional shares, at a public offering price of \$20.00 per share, and we sold and issued 274,999 shares of our Class A common stock at a price of \$20.00 per share in a private placement. As a result of the offerings, we received net proceeds of approximately \$76.3 million, after deducting underwriting discounts and commissions of approximately \$5.6 million and additional net offering-related expenses of \$3.3 million, for total net expenses of \$8.9 million. The net offering proceeds have been invested into money market funds and certificates of deposit.

As of September 30, 2011 and December 31, 2010, we had cash and cash equivalents and short-term investments of \$95.8 million and \$13.8 million, respectively. Cash and cash equivalents balances consist of operating cash on deposit with our financial institutions, money market funds and certificates of deposit with original maturities of three months or less. Short-term investments consist of U.S. Treasury securities. Amounts on deposit with third-party financial institutions exceed the applicable Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation insurance limits, as applicable. We believe that cash from operations, cash and cash equivalent balances and the net proceeds we received in connection with our initial public offering will be sufficient to meet our ongoing operating activities, working capital, capital expenditures and other capital requirements for at least the next 12 months.

During March 2011, we entered into a loan and security agreement with a financial institution to establish a line of credit of \$4.0 million, secured by substantially all our assets other than our intellectual property, to be used for general business purposes. The line of credit contains financial and non-financial covenants. As of September 30, 2011, we were in compliance with all covenants. The line of credit is available through March 2013. During March 2011, we executed a standby letter of credit of \$1.5 million in connection with the lease of our new Seattle offices and reserved this amount against the line of credit, which reduces the available line to \$2.5 million. As of September 30, 2011, there were no other amounts outstanding under the line of credit.

The following table presents selected cash flow data for the nine months ended September 30, 2011 and 2010:

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(in thousands, unaudited)</b>	
<b>Cash Flow Data:</b>		
Cash flows provided by operating activities	\$ 14,019	\$ 644
Cash flows provided by (used in) investing activities	(7,966)	1,590
Cash flows provided by financing activities	77,482	587

***Cash Flows Provided By Operating Activities***

For the nine months ended September 30, 2011, net cash provided by operating activities was \$14.0 million compared to net cash provided by operating activities of \$0.6 million for the nine months ended September 30, 2010.

## Edgar Filing: ZILLOW INC - Form 10-Q

Cash flows provided by operating activities of \$14.0 million for the nine months ended September 30, 2011 was driven by net income of \$0.2 million, adjusted by depreciation and amortization expense of \$5.4 million, the facility exit charge of \$1.7 million and share-based compensation expense of \$1.3 million. Changes in operating assets and liabilities increased cash provided by operating activities for the nine months ended September 30, 2011 by \$4.5 million.



**Table of Contents**

Cash flows provided by operating activities of \$0.6 million for the nine months ended September 30, 2010 was driven by net loss of \$6.3 million, adjusted by depreciation and amortization expense and share-based compensation expense of \$3.9 million and \$1.3 million, respectively. Changes in operating assets and liabilities increased cash provided by operating activities for the nine months ended September 30, 2010 by \$1.6 million.

**Cash Flows Provided By (Used In) Investing Activities**

Our primary investing activities include the purchase and maturity of short-term investments and the purchase of property and equipment and intangible assets.

For the nine months ended September 30, 2011, we used \$8.0 million of net cash in investing activities. This was the result of \$8.5 million of purchases for property and equipment and intangible assets and \$1.0 million paid in connection with our March 2011 acquisition of the operating assets of a real estate agent and rental property manager marketing service company, partially offset by \$1.5 million of net proceeds from maturities of short-term investments.

For the nine months ended September 30, 2010, net cash provided by investing activities was approximately \$1.6 million. This was the result of approximately \$5.7 million of net proceeds from maturities of short-term investments, partially offset by approximately \$4.1 million of purchases for property and equipment and intangible assets.

**Cash Flows Provided By Financing Activities**

Our financing activities have primarily resulted from the exercise of employee non-qualified stock options and for the nine months ended September 30, 2011, also consisted of payments for deferred offering costs.

For the nine months ended September 30, 2011, net cash provided by financing activities was approximately \$77.5 million, which was primarily the result of \$70.8 million in proceeds from our initial public offering, net of offering costs, approximately \$5.5 million in proceeds from our concurrent private placement, and \$1.2 million in proceeds from the issuance of Class A common stock from the exercise of stock options.

For the nine months ended September 30, 2010, net cash provided by financing activities was approximately \$0.6 million, which was due to proceeds from the issuance of Class A common stock from the exercise of stock options.

**Off-Balance Sheet Arrangements**

We did not have any off-balance sheet arrangements as of September 30, 2011 or December 31, 2010.

**Contractual Obligations**

We have various operating leases for office space and equipment. We have entered into an operating lease for our current headquarters in Seattle, Washington under which we will be obligated to make payments beginning in December 2012 through November 2022. Our prior headquarters in Seattle, Washington is under an operating lease expiring in February 2013. We also have purchase obligations for content related to our websites. We do not have any debt or capital lease obligations. The following table provides a summary of our operating lease obligations and purchase obligations as of September 30, 2011 (unaudited):

	Total	Payment Due By Period			More Than 5 Years
		Less Than 1 Year	1-3 Years (in thousands)	3-5 Years	
Operating lease obligations	\$ 22,127	\$ 1,598	\$ 4,059	\$ 3,630	\$ 12,840
Purchase obligations	2,851	1,031	1,040	780	
<b>Total</b>	<b>\$ 24,978</b>	<b>\$ 2,629</b>	<b>\$ 5,099</b>	<b>\$ 4,410</b>	<b>\$ 12,840</b>

## Edgar Filing: ZILLOW INC - Form 10-Q

The contractual commitment amounts in the table above are associated with agreements that are enforceable and legally binding. Obligations under contracts that we can cancel without a significant penalty are not included in the table above.

### **Critical Accounting Policies and Estimates**

Our financial statements are prepared in accordance with U.S. generally accepted accounting principles, or GAAP. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures. We evaluate our estimates and assumptions on an ongoing basis. Our estimates are based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Our actual results could differ from these estimates.

## **Table of Contents**

We believe that the assumptions and estimates associated with revenue recognition, the allowance for doubtful accounts, website and software development costs, recoverability of intangible assets with definite lives and other long-lived assets and share-based compensation have the greatest potential impact on our financial statements. Therefore, we consider these to be our critical accounting policies and estimates.

### ***Revenue Recognition***

Our revenue is primarily derived from advertising services. In general, we recognize revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered to the customer, (iii) the fee is fixed or determinable, and (iv) collectability is reasonably assured. We consider a signed agreement, a binding insertion order or other similar documentation reflecting the terms and conditions under which products will be provided to be persuasive evidence of an arrangement. Collectability is assessed based on a number of factors, including payment history and the creditworthiness of a customer. If it is determined that collection is not reasonably assured, revenue is not recognized until collection becomes reasonably assured, which is generally upon receipt of cash.

Our marketplace revenues consist of subscriptions sold to real estate agents under our Premier Agent program, and CPC advertising related to our Zillow Mortgage Marketplace sold to mortgage lenders. Subscription advertising revenues are recognized on a straight-line basis during the contractual period over which the advertising is delivered. Typical terms of our Premier Agent subscription contracts are six months. For Zillow Mortgage Marketplace, we recognize revenue when a user clicks on a mortgage advertisement or on a link to obtain additional information about a mortgage loan quote.

Display revenues primarily consist of graphical advertising sold on a CPM basis to advertisers. We recognize these revenues as impressions are delivered to users interacting with our websites or mobile applications.

### ***Allowance for Doubtful Accounts***

We review accounts receivable on a regular basis and estimate an amount of losses for uncollectible accounts based on our historical collections experience, age of the receivable, knowledge of the customer and the condition of the general economy and industry as a whole.

### ***Website and Software Development Costs***

The costs incurred in the preliminary stages of website and software development are expensed as incurred. Once an application has reached the development stage, internal and external costs, if direct and incremental and deemed by management to be significant, are capitalized in property and equipment and amortized on a straight-line basis over their estimated useful lives. Maintenance and enhancement costs (including those costs in the post-implementation stages) are typically expensed as incurred, unless such costs relate to substantial upgrades and enhancements to the websites (or software) that result in added functionality, in which case the costs are capitalized and amortized on a straight-line basis over the estimated useful lives.

Capitalized development activities placed in service are amortized over the expected useful lives of those releases, currently estimated at one year. Estimated useful lives of website and software development activities are reviewed frequently and adjusted as appropriate to reflect upcoming development activities that may include significant upgrades and/or enhancements to the existing functionality.

### ***Recoverability of Intangible Assets with Definite Lives and Other Long-Lived Assets***

We evaluate intangible assets and other long-lived assets for impairment whenever events or circumstances indicate they may not be recoverable. Recoverability is measured by comparing the carrying amount of an asset group to future undiscounted net cash flows expected to be generated. We group assets for purposes of such review at the lowest level for which identifiable cash flows of the asset group are largely independent of the cash flows of the other groups of assets and liabilities. If this comparison indicates impairment, the amount of impairment to be recognized is calculated as the difference between the carrying value and the fair value of the asset group.

## **Table of Contents**

### ***Share-Based Compensation***

We measure compensation expense for all share-based awards at fair value on the date of grant and recognize compensation expense over the service period for awards expected to vest. We use the Black-Scholes-Merton option-pricing model to determine the fair-value for awards and recognize compensation expense on a straight-line basis over the awards' vesting periods. Determining the fair value of share-based awards at the grant date requires judgment. If any of the assumptions used in the Black-Scholes-Merton model changes significantly, share-based compensation for future awards may differ materially compared with the awards granted previously. In valuing our options, we make assumptions about risk-free interest rates, dividend yields, volatility, and weighted-average expected lives, including estimated forfeiture rates, of the options.

***Risk-free rate.*** Risk-free interest rates are derived from U.S. Treasury securities as of the option grant date.

***Expected dividend yields.*** Expected dividend yields are based on our historical dividend payments, which have been zero to date.

***Volatility.*** Absent a historical public market for our shares, we have estimated volatility of our share price based on the published historical volatilities of industry peers in the online publishing market (primarily the financial and real estate services industries) representing the verticals in which we operate.

***Expected term.*** We estimate the weighted-average expected life of the options as the average of the vesting option schedule and the term of the award, since, due to the limited period of time share-based awards have been exercisable, we do not have sufficient historical exercise data to provide a reasonable basis upon which to estimate the expected term. The term of the award is estimated using the simplified method as the awards granted are plain vanilla share options.

***Forfeiture rate.*** Forfeiture rates are estimated using historical actual forfeiture trends as well as our judgment of future forfeitures. These rates are evaluated at least quarterly and any change in compensation expense is recognized in the period of the change. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period in which the estimates are revised. We consider many factors when estimating expected forfeitures, including the types of awards and employee class. Actual results, and future changes in estimates, may differ substantially from management's current estimates.

**Table of Contents**

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to market risks in the ordinary course of our business. These risks primarily consist of fluctuations in interest rates.

We do not have any long-term borrowings as of September 30, 2011 or December 31, 2010.

Under our current investment policy, we invest our excess cash in money market funds, FDIC-insured certificates of deposit and U.S. Treasury securities. Our current investment policy seeks first to preserve principal, second to provide liquidity for our operating and capital needs and third to maximize yield without putting our principal at risk.

Our cash and cash equivalents are exposed to market risk due to the fluctuation of prevailing interest rates that may reduce the yield or the fair value. As our cash and cash equivalent portfolio is short-term in nature, we do not believe an immediate 10% increase in interest rates would have a material effect on the fair market value of our portfolio, and therefore we do not expect our results of operations or cash flows to be materially affected by a sudden change in market interest rates.

**Table of Contents**

**Item 4. Controls and Procedures**

***Evaluation of Disclosure Controls and Procedures***

The Company maintains disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended). Management, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b) as of September 30, 2011. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that these disclosure controls and procedures were effective as of September 30, 2011.

***Changes in Internal Control Over Financial Reporting***

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

In July 2011, Traffic Information, LLC filed a complaint against us, and other defendants, for patent infringement in the U.S. District Court for the Eastern District of Texas, Marshall Division. The complaint alleges, among other things, that we may have infringed a patent held by Traffic Information, LLC purporting to cover a System for Providing Traffic Information related to delivering traffic information to mobile devices. The complaint does not specify how we are allegedly infringing, but seeks injunctive relief and unspecified damages. We intend to vigorously defend the claims.

In September 2011, I2Z Technology, LLC filed a complaint against us, and other defendants, for patent infringement in the U.S. District Court for the District of Oregon, Portland Division. The complaint alleges, among other things, that we may have infringed a patent held by I2Z Technology, LLC purporting to cover a Method and System for Synchronization of Simultaneous Displays of Related Data Sources. The complaint seeks injunctive relief and unspecified damages. We intend to vigorously defend the claims.

Although the results of litigation cannot be predicted with certainty, we currently believe we have substantial and meritorious defenses to these claims and that the final outcome of these litigation matters will not have a material effect on our business, financial position, results of operations or cash flow.

Except as noted above, there have been no material developments in legal proceedings. For a description of previously reported legal proceedings, refer to Part II, Item 1, Legal Proceedings, of our Quarterly Report on Form 10-Q for the three months ended June 30, 2011.

From time to time, we are involved in litigation and claims that arise in the ordinary course of business and although we cannot be certain of the outcome of any such litigation or claims, nor the amount of damages and exposure that we could incur, we currently believe that the final disposition of such matters will not have a material effect on our business, financial position, results of operations or cash flow. Regardless of the outcome, litigation can have an adverse impact on us because of defense and settlement costs, diversion of management resources and other factors.

## **Table of Contents**

### **Item 1A. Risk Factors**

*Our business is subject to numerous risks. You should carefully consider the following risk factors and all other information contained in this Quarterly Report on Form 10-Q and in our registration statement filed with the SEC in connection with our IPO. Any of these risks could harm our business, results of operations, and financial condition and our prospects. In addition, risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results.*

#### **Risks Related to Our Business**

***We have incurred significant operating losses in the past and we may not be able to generate sufficient revenue to be profitable over the long term.***

Since our inception in December 2004, we have incurred significant net operating losses and, as of September 30, 2011, we had an accumulated deficit of \$78.5 million. Although we have experienced significant revenue growth, we expect that our revenue growth rate will decline in the future as a result of a variety of factors, including the maturation of our business. At the same time, we also expect our costs to increase in future periods as we continue to expend substantial financial resources to develop and expand our business, including on:

product development;

sales and marketing;

our technology infrastructure;

strategic opportunities, including commercial relationships and acquisitions; and

general administration, including legal and accounting expenses related to being a public company.

These investments may not result in increased revenue or growth in our business. If we fail to continue to grow our revenue and overall business and to manage our expenses, we may continue to incur significant losses in the future and not be able to achieve or maintain profitability.

***If real estate and mortgage professionals or other advertisers reduce or end their advertising spending with us and we are unable to attract new advertisers, our business would be harmed.***

Our current financial model depends on advertising revenues generated almost entirely through sales to real estate agents and brokerages, mortgage lenders and advertisers in categories relevant to real estate. Our ability to attract and retain advertisers, and ultimately to generate advertising revenue, depends on a number of factors, including:

increasing the number of consumers of our products and services;

competing effectively for advertising dollars with other online media companies;

continuing to develop our advertising products and services;

keeping pace with changes in technology and with our competitors; and



offering an attractive return on investment to our advertisers for their advertising spending with us.

While real estate agents participating in our subscription-based Premier Agent program generally commit to contract terms of six months, we do not have long-term contracts with most of our other advertisers. Those advertisers could choose to modify or discontinue their relationships with us with little or no advance notice. In addition, as existing subscriptions for our Premier Agent program expire, we may not be successful in renewing these subscriptions, securing new subscriptions or increasing the amount of revenue we earn for a given subscription over time. We may not succeed in capturing a greater share of our advertisers' spending if we are unable to convince advertisers of the effectiveness or superiority of our products as compared to alternatives, including traditional offline advertising media such as television and newspapers. If current advertisers reduce or end their advertising spending with us and we are unable to attract new advertisers, our advertising revenues and business, results of operations and financial condition would be harmed. In addition, if we do not realize the benefits we expect from our relationship with Yahoo! Real Estate and other strategic relationships we may enter into, including for example, the generation of additional advertising revenue opportunities, our business could be harmed.

***If we do not innovate and provide products and services that are attractive to our users and to our advertisers, our business could be harmed.***

Our success depends on our continued innovation to provide products and services that make our website and mobile applications useful for consumers and real estate and mortgage professionals and attractive to our advertisers. As a result, we must continually invest significant resources in research and development in order to improve the attractiveness and comprehensiveness of our products and services and effectively incorporate new Internet and mobile technologies into them. If we are unable to provide products and services that users, including real estate professionals, want to use, then users may become dissatisfied and use

**Table of Contents**

competitors' websites and mobile applications. If we are unable to continue offering innovative products and services, we may be unable to attract additional users and advertisers or retain our current users and advertisers, which could harm our business, results of operations and financial condition.

*We may be unable to increase awareness of the Zillow brand cost-effectively, which could harm our business.*

We rely heavily on the Zillow brand, which we believe is a key asset of our company. Awareness and perceived quality and differentiation of the Zillow brand are important aspects of our efforts to attract and expand the number of consumers who use our website and mobile applications. Should the competition for awareness and brand preference increase among online real estate information providers, we may not be able to successfully maintain or enhance the strength of our brand. If we are unable to maintain or enhance user and advertiser awareness of our brand cost-effectively, our business, results of operations and financial condition could be harmed.

*We are dependent on the real estate industry, and changes to that industry, or declines in the real estate market or increases in mortgage interest rates, could reduce the demand for our products and services.*

Our financial prospects are significantly dependent on real estate shoppers using our services. Real estate shopping patterns depend on the overall health of the real estate market. Changes to the regulation of the real estate industry, including mortgage lending, may negatively impact the prevalence of home ownership. Changes to the real estate industry, declines in the real estate market or increases in mortgage interest rates could reduce demand for our services. Real estate markets also may be negatively impacted by a significant natural disaster, such as earthquake, fire, flood or other disruption.

*We may be unable to maintain or establish relationships with real estate brokerages, real estate listing aggregators, multiple listing services, apartment management companies, home builders and other third-party listing providers, which could limit the information we are able to provide to our users.*

Our ability to attract users to our websites and mobile applications depends to some degree on providing a robust number of for sale and rental listings. To provide these listings, we maintain relationships with real estate brokerages, real estate listing aggregators, multiple listing services, apartment management companies, home builders, other third-party listing providers, and homeowners and their real estate agents to include listing data in our services. Many of our agreements with real estate listing providers are short-term agreements that may be terminated with limited notice. The loss of some of our existing relationships with listing providers, whether due to termination of agreements or otherwise, or an inability to continue to add new listing providers, may cause our listing data to omit information important to users of our products and services. This could reduce user confidence in the sale and rental data we provide and make us less popular with consumers, which could harm our business, results of operations and financial condition.

*We may be unable to maintain or establish relationships with data providers, which could limit the information we are able to provide to our users and impair our ability to attract or retain users.*

We obtain real estate data, such as sale transactions, property descriptions, tax-assessed value and property taxes paid, under licenses from third-party data providers. We use this data to enable the development, maintenance and improvement of our information services, including Zestimates and Rent Zestimates and our living database of homes. We have invested significant time and resources to develop proprietary algorithms, valuation models, software and practices to use and improve upon this specific data. We may be unable to renew our licenses with these data providers, or we may be able to do so only on terms that are less favorable to us, which could harm our ability to continue to develop, maintain and improve these information services and could harm our business, results of operations and financial condition.

*We may in the future be subject to disputes regarding the accuracy of our Zestimates and Rent Zestimates.*

We provide our users with Zestimate and Rent Zestimate home and rental valuations. A Zestimate is our estimated current market value of a home based on proprietary automated valuation models that apply advanced algorithms to analyze our data; it is not an appraisal. A Rent Zestimate is our estimated current monthly rental price of a home, using similar automated valuation models that we have designed to address the unique attributes of rental homes. Revisions to our automated valuation models, or the algorithms that underlie them, may cause certain Zestimates or Rent Zestimates to vary from our expectations for those Zestimates or Rent Zestimates. In addition, from time to time, users disagree with our Zestimates and Rent Zestimates. Any such variation in Zestimates or Rent Zestimates or disagreements could result in distraction from our business or potentially harm our reputation and could result in legal disputes.

*We face competition to attract consumers to our websites and mobile applications, which could impair our ability to continue to grow the number of users who use our websites and mobile applications, which would harm our business, results of operations and financial*

*condition.*

Our success depends on our ability to continue to attract additional consumers to our websites and mobile applications. Our existing and potential competitors include companies that operate, or could develop, national and local real estate and mortgage

---

**Table of Contents**

websites. These companies could devote greater technical and other resources than we have available, have a more accelerated time frame for deployment and leverage their existing user bases and proprietary technologies to provide products and services that consumers might view as superior to our offerings. Any of our future or existing competitors may introduce different solutions that attract consumers or provide solutions similar to our own but with better branding or marketing resources. If we are unable to continue to grow the number of consumers who use our websites and mobile applications, our business, results of operations and financial condition would be harmed.

***We may be unable to compete successfully against our existing or future competitors in attracting advertisers, which could harm our business, results of operations and financial condition.***

We compete to attract advertisers with media sites, including websites dedicated to providing real estate and mortgage information and services to real estate professionals and consumers, and major Internet portals, general search engines and social media sites, as well as other online companies. We also compete for a share of advertisers' overall marketing budgets with traditional media such as television, magazines, newspapers and home/apartment guide publications, particularly with respect to advertising dollars spent at the local level by real estate professionals to advertise their qualifications and listings. Large companies with significant brand recognition have large numbers of direct sales personnel and substantial proprietary advertising inventory and web traffic, which may provide a competitive advantage. To compete successfully for advertisers against future and existing competitors, we must continue to invest resources in developing our advertising platform and proving the effectiveness and relevance of our advertising products and services. Pressure from competitors seeking to acquire a greater share of our advertisers' overall marketing budget could adversely affect our pricing and margins, lower our revenues, and increase our research and development and marketing expenses. If we are unable to compete successfully against our existing or future competitors, our business, financial condition or results of operations would be harmed.

***Our dedication to making decisions based primarily on the best interests of consumers may cause us to forgo short-term gains.***

Our guiding principle is to build our business by making decisions based primarily upon the best interests of consumers, which we believe has been essential to our success in increasing our user growth rate and engagement and has served the long-term interests of our company and our shareholders. In the past, we have forgone, and we will in the future forgo, certain expansion or short-term revenue opportunities that we do not believe are in the best interests of consumers, even if such decisions negatively impact our results of operations in the short term. In addition, our philosophy of putting consumers first may negatively impact our relationships with our existing or prospective advertisers. This could result in a loss of advertisers which could harm our revenues and results of operations. For example, we believe that some real estate agents have chosen not to purchase our Premier Agent subscriptions because we display a Zestimate on their for sale listings. However, we believe it is valuable to consumers to have access to a valuation starting point on all homes and so we display a Zestimate on every home in our database for which we have sufficient data to produce the Zestimate. Similarly, we gather and make available to our consumers reviews on real estate and mortgage professionals, even if those reviews are unfavorable. Although real estate and mortgage professionals who receive unfavorable reviews may be less likely to purchase our advertising products and services, we continue to post favorable and unfavorable reviews because we believe the reviews are useful to consumers in finding the right professional. Our principle of making decisions based primarily upon the best interests of consumers may not result in the long-term benefits that we expect, in which case our user traffic and engagement, business and results of operations could be harmed.

***If we fail to manage our growth effectively, our brand, results of operations and business could be harmed.***

We have experienced rapid growth in our headcount and operations, which places substantial demand on management and our operational infrastructure. Most of our employees have been with us for fewer than two years. As we continue to grow, we must effectively integrate, develop and motivate a large number of new employees, while maintaining the beneficial aspects of our company culture. In particular, we intend to pursue strategic opportunities and make substantial investments in our technology and development and sales and marketing organizations. If we do not manage the growth of our business and operations effectively, the quality of our services and efficiency of our operations could suffer, which could harm our brand, results of operations and overall business.

***If use of the Internet and mobile technology, particularly with respect to online real estate products and services, does not continue to increase as rapidly as we anticipate, our business could be harmed.***

Our future success is substantially dependent on the continued use of the Internet and mobile technology as effective media of business and communication by our consumers. Internet and mobile technology use may not continue to develop at historical rates, and consumers may not continue to use the Internet or mobile technology as media for information exchange. Further, these media may not be accepted as viable long-term outlets for information for a number of reasons, including actual or perceived lack of security of information and possible disruptions of service or connectivity. If consumers begin to access real estate information through other media and we fail to innovate, our business may be negatively impacted.



---

## **Table of Contents**

***We rely on the performance of highly skilled personnel, and if we are unable to attract, retain and motivate well-qualified employees, our business could be harmed.***

We believe our success has depended, and continues to depend, on the efforts and talents of our management and our highly skilled team of employees, including our software engineers, statisticians, marketing professionals and advertising sales staff. Our future success depends on our continuing ability to attract, develop, motivate and retain highly qualified and skilled employees. The loss of any of our senior management or key employees could materially adversely affect our ability to build on the efforts they have undertaken and to execute our business plan, and we may not be able to find adequate replacements. We cannot ensure that we will be able to retain the services of any members of our senior management or other key employees. If we do not succeed in attracting well-qualified employees or retaining and motivating existing employees, our business could be harmed.

***Any significant disruption in service on our websites or in our network could damage our reputation and result in a loss of users of our products and services and of advertisers, which could harm our business, results of operations and financial condition.***

Our brand, reputation and ability to attract users and advertisers depend on the reliable performance of our network infrastructure and content delivery processes. We have experienced minor interruptions in these systems in the past, including server failures that temporarily slowed the performance of our websites and mobile applications, and we may experience interruptions in the future. Interruptions in these systems, whether due to system failures, computer viruses or physical or electronic break-ins, could affect the security or availability of our products and services on our websites and mobile applications and prevent or inhibit the ability of users to access our services. Problems with the reliability or security of our systems could harm our reputation, result in a loss of users of our products and services and of advertisers and result in additional costs, any of which could harm our business, results of operations and financial condition.

Substantially all of the communications, network and computer hardware used to operate our websites are located at facilities in the area. We do not own or control the operation of these facilities. Our systems and operations are vulnerable to damage or interruption from fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, electronic and physical break-ins, computer viruses, earthquakes and similar events. The occurrence of any of the foregoing events could result in damage to our systems and hardware or could cause them to fail completely, and our insurance may not cover such events or may be insufficient to compensate us for losses that may occur.

A failure of our systems at one site could result in reduced functionality for our users, and a total failure of our systems could cause our websites or mobile applications to be inaccessible. Problems faced by our third-party web hosting providers with the telecommunications network providers with which they contract or with the systems by which they allocate capacity among their customers, including us, could adversely affect the experience of our users. Our third-party web hosting providers could decide to close their facilities without adequate notice. Any financial difficulties, such as bankruptcy reorganization, faced by our third-party web hosting providers or any of the service providers with whom they contract may have negative effects on our business, the nature and extent of which are difficult to predict. If our third-party web hosting providers are unable to keep up with our growing needs for capacity, this could harm our business.

We do not carry business interruption insurance sufficient to compensate us for the potentially significant losses, including the potential harm to the future growth of our business that may result from interruptions in our service as a result of system failures. Any errors, defects, disruptions or other performance problems with our services could harm our reputation and harm our business, results of operations and financial condition.

***We may make acquisitions and investments, which could result in operating difficulties, dilution and other harmful consequences.***

We expect to evaluate a wide array of potential strategic opportunities. For example, in March 2011, we acquired the operating assets of a real estate agent and rental property manager marketing service, and in October 2011, we acquired substantially all of the assets of Diverse Solutions, Inc., a company that helps real estate agents market their businesses and improve their personal websites. Any transactions that we enter into could be material to our financial condition and results of operations. The process of integrating an acquired company, business or technology could create unforeseen operating difficulties and expenditures. The areas where we face risks include:

diversion of management time and focus from operating our business to acquisition integration challenges;

implementation or remediation of controls, procedures and policies at the acquired company;

## Edgar Filing: ZILLOW INC - Form 10-Q

coordination of product, engineering and sales and marketing functions;

retention of employees from the acquired company;

liability for activities of the acquired company before the acquisition;

litigation or other claims arising in connection with the acquired company; and

in the case of foreign acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political and regulatory risks associated with specific countries.

---

## **Table of Contents**

Our failure to address these risks or other problems encountered in connection with our past or future acquisitions and investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities and harm our business, results of operations and financial condition.

*We are subject to a variety of federal and state laws, many of which are unsettled and still developing and which could subject us to claims or otherwise harm our business.*

We are subject to a variety of federal and state laws that are continuously evolving and developing, including laws regarding the real estate and mortgage industries, Internet-based businesses and businesses that rely on advertising. These laws can be costly to comply with, can require significant management time and effort, and can subject us to claims or other remedies. These laws may conflict with each other and if we comply with the laws of one jurisdiction, we may find that we are violating laws of another jurisdiction. Additionally, our ability to provide a specific target audience to advertisers is a significant competitive advantage. Any legislation reducing this ability would have a negative impact on our business and results of operations.

If we are unable to comply with these laws or regulations, if we become liable under these laws or regulations or if unfavorable regulations or unfavorable interpretations of existing regulations by courts or regulatory bodies are implemented, we could be directly harmed and forced to implement new measures to reduce our exposure to this liability and it could cause the development of product or service offerings in affected markets to become impractical. This may require us to expend substantial resources or to discontinue certain products or services, limit our ability to expand our product and services offerings or expand into new markets or otherwise harm our business, results of operations and financial condition. In addition, the increased attention focused upon liability issues as a result of lawsuits and legislative proposals could harm our reputation or otherwise impact the growth of our business. Any costs incurred as a result of this potential liability could harm our business and results of operations.

We assist with the processing of customer credit card transactions which results in us receiving personally identifiable information. This information is increasingly subject to legislation and regulation in the United States. This legislation and regulation is generally intended to protect the privacy and security of personal information, including credit card information, that is collected, processed and transmitted. We could be adversely affected if government regulations require us to significantly change our business practices with respect to this type of information.

*We may be unable to continue to use the domain names that we use in our business, or prevent third parties from acquiring and using domain names that infringe on, are similar to, or otherwise decrease the value of our brand or our trademarks or service marks.*

We have registered domain names for our websites that we use in our business, such as Zillow.com, Postlets.com and DiverseSolutions.com. If we lose the ability to use a domain name, we may incur significant expenses to market our products and services under a new domain name, which could harm our business. In addition, our competitors could attempt to capitalize on our brand recognition by using domain names similar to ours. Domain names similar to ours have been registered in the United States and elsewhere. We may be unable to prevent third parties from acquiring and using domain names that infringe on, are similar to, or otherwise decrease the value of our brand or our trademarks or service marks. Protecting and enforcing our rights in our domain names and determining the rights of others may require litigation, which could result in substantial costs and diversion of management's attention.

*We may be unable to adequately protect our intellectual property, which could harm the value of our brand and our business.*

We regard our intellectual property as critical to our success, and we rely on trademark, copyright and patent law, trade secret protection and contracts to protect our proprietary rights. If we are not successful in protecting our intellectual property, the value of our brand and our business, results of operations and financial condition could be harmed.

While we believe that our issued patents and pending patent applications help to protect our business, there can be no assurance that our operations do not, or will not, infringe valid, enforceable patents of third parties or that competitors will not devise new methods of competing with us that are not covered by our patents or patent applications. There also can be no assurance that our patent applications will be approved, that any patents issued will adequately protect our intellectual property, that such patents will not be challenged by third parties or found to be invalid or unenforceable or that our patents will be effective in preventing third parties from utilizing a copycat business model to offer the same products or services. Moreover, we rely on intellectual property and technology developed or licensed by third parties, and we may not be able to obtain licenses and technologies from these third parties on reasonable terms or at all.

Effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our products and services may be provided. The laws of certain countries do not protect proprietary rights to the same extent as the laws of the United States and, therefore, in certain jurisdictions, we may be unable to protect intellectual property and our proprietary technology adequately against



## Edgar Filing: ZILLOW INC - Form 10-Q

unauthorized third-party copying or use, which could harm our competitive position. We have licensed in the past, and expect to license in the future, certain of our proprietary rights, such as trademarks or copyrighted material, to third parties. These licensees may take actions that might diminish the value of our proprietary rights or harm our reputation, even if we

---

## **Table of Contents**

have agreements prohibiting such activity. To the extent third parties are obligated to indemnify us for breaches of our intellectual property rights, these third parties may be unable to meet these obligations. Any of these events could harm our business, results of operations or financial condition.

***Intellectual property disputes are costly to defend and could harm our business, results of operations, financial condition and reputation.***

From time to time, we face allegations that we have infringed the trademarks, copyrights, patents and other intellectual property rights of third parties. We are currently subject to patent infringement claims. These claims allege, among other things, that aspects of our technology infringe upon the plaintiffs' patents. If we are not successful in defending ourselves against these claims, we may be required to pay damages and may be subject to injunctions, each of which could harm our business, results of operations, financial condition and reputation. We may be subject to future claims or allegations relating to our intellectual property rights. As we grow our business and expand our operations we expect that we will continue to be subject to intellectual property claims and allegations. Patent and other intellectual property disputes or litigation may be protracted and expensive, and the results are difficult to predict and may require us to stop offering certain products, services or features, purchase licenses which may be expensive to procure or modify our products or services. In addition, patent or other intellectual property disputes or litigation may result in significant settlement costs. Any of these events could harm our business, results of operations, financial condition and reputation.

In addition, we use open source software in our services and will continue to use open source software in the future. From time to time, we may be subject to claims brought against companies that incorporate open source software into their products or services, claiming ownership of, or demanding release of, the source code, the open source software and/or derivative works that were developed using such software, or otherwise seeking to enforce the terms of the applicable open source license. These claims could also result in litigation, require us to purchase a costly license or require us to devote additional research and development resources to changing our products or services, any of which would have a negative effect on our business and results of operations.

Even if these matters do not result in litigation or are resolved in our favor or without significant cash settlements, the time and resources necessary to resolve them could harm our business, results of operations, financial condition and reputation.

***Confidentiality agreements with employees and others may not adequately prevent disclosure of trade secrets and other proprietary information.***

In order to protect our technologies and processes, we rely in part on confidentiality agreements with our employees, licensees, independent contractors and other advisors. These agreements may not effectively prevent disclosure of confidential information, including trade secrets, and may not provide an adequate remedy in the event of unauthorized disclosure of confidential information. In addition, others may independently discover our trade secrets and proprietary information, and in such cases we could not assert any trade secret rights against such parties. To the extent that our employees, contractors or other third parties with whom we do business use intellectual property owned by others in their work for us, disputes may arise as to the rights in related or resulting know-how and inventions. The loss of trade secret protection could make it easier for third parties to compete with our products by copying functionality. In addition, any changes in, or unexpected interpretations of, intellectual property laws may compromise our ability to enforce our trade secret and intellectual property rights. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain protection of our trade secrets or other proprietary information could harm our business, results of operations, reputation and competitive position.

***We may be unable to halt the operations of websites that aggregate or misappropriate our data.***

From time to time, third parties have misappropriated our data through website scraping, robots or other means and aggregated this data on their websites with data from other companies. In addition, copycat websites have misappropriated data on our network and attempted to imitate our brand or the functionality of our websites. When we have become aware of such websites, we have employed technological or legal measures in an attempt to halt their operations. However, we may be unable to detect all such websites in a timely manner and, even if we could, technological and legal measures may be insufficient to halt their operations. In some cases, particularly in the case of websites operating outside of the United States, our available remedies may not be adequate to protect us against the impact of the operation of such websites. Regardless of whether we can successfully enforce our rights against the operators of these websites, any measures that we may take could require us to expend significant financial or other resources, which could harm our business, results of operations or financial condition. In addition, to the extent that such activity creates confusion among consumers or advertisers, our brand and business could be harmed.

***If our security measures are compromised, consumers may curtail use of our products and services and advertisers may reduce their advertising on our websites.***

## Edgar Filing: ZILLOW INC - Form 10-Q

Our products and services involve the storage and transmission of users' information, some of which may be private, and security breaches could expose us to a risk of loss or exposure of this information, which could result in potential liability and litigation. For example, a hacker could steal a user's profile password and manipulate information about that user's home or post to a forum while posing as that user. Like all websites, our websites are vulnerable to computer viruses, break-ins, phishing attacks, attempts to overload our servers with denial-of-service or other attacks and similar disruptions from unauthorized use of our computer

---

**Table of Contents**

systems, any of which could lead to interruptions, delays, or website shutdowns, causing loss of critical data or the unauthorized disclosure or use of personal or other confidential information. If we experience compromises to our security that result in website performance or availability problems, the complete shutdown of our websites or mobile applications, or the loss or unauthorized disclosure of confidential information, our users and advertisers may lose trust and confidence in us, and users may decrease the use of our websites or stop using our websites in their entirety, and advertisers may decrease or stop advertising on our websites. Further, outside parties may attempt to fraudulently induce employees, users or advertisers to disclose sensitive information in order to gain access to our information or our users' or advertisers' information. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently, often are not recognized until launched against a target and may originate from less regulated and remote areas around the world, we may be unable to proactively address these techniques or to implement adequate preventative measures. Any or all of these issues could negatively impact our ability to attract new users and increase engagement by existing users, cause existing users to curtail or stop use of our products or services or close their accounts, cause existing advertisers to cancel their contracts, or subject us to third-party lawsuits, regulatory fines or other action or liability, thereby harming our business, results of operations and financial condition.

***We are subject to a number of risks related to credit card and debit card payments we accept.***

We accept payments through credit and debit card transactions. For credit and debit card payments, we pay interchange and other fees, which may increase over time. An increase in those fees would require us to either increase the prices we charge or suffer an increase in our operating expenses, either of which could harm our business, financial condition and results of operations.

We depend on processing vendors to complete credit and debit card transactions. If we or our processing vendors fail to maintain adequate systems for the authorization and processing of credit card transactions, it could cause one or more of the major credit card companies to disallow our continued use of their payment products. In addition, if these systems fail to work properly and, as a result, we do not charge our customers' credit cards on a timely basis or at all, our business, revenue, results of operations and financial condition could be harmed.

We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, which could change or be reinterpreted to make it more difficult for us to comply. We are required to comply with payment card industry security standards. Failing to comply with those standards may violate payment card association operating rules, federal and state laws and regulations, and the terms of our contracts with payment processors. Any failure to comply fully also may subject us to fines, penalties, damages and civil liability, and may result in the loss of our ability to accept credit and debit card payments. Further, there is no guarantee that such compliance will prevent illegal or improper use of our payment systems or the theft, loss, or misuse of data pertaining to credit and debit cards, card holders and transactions.

If we fail to adequately control fraudulent credit card transactions, we may face civil liability, diminished public perception of our security measures and significantly higher credit card-related costs, each of which could harm our business, results of operations and financial condition.

If we are unable to maintain our chargeback rate or refund rates at acceptable levels, our processing vendors may increase our transaction fees or terminate their relationships with us. Any increases in our credit and debit card fees could harm our results of operations, particularly if we elect not to raise our rates for our service to offset the increase. The termination of our ability to process payments on any major credit or debit card would significantly impair our ability to operate our business.

***We have pledged substantially all of our assets to secure indebtedness.***

In March 2011, we entered into an agreement with a financial institution to establish a \$4.0 million line of credit to be used for general business purposes. Indebtedness we incur under this agreement is secured by substantially all our assets other than our intellectual property. If we default on our obligations under this agreement, the financial institution may foreclose on our assets, which would materially and adversely impact our business. On March 22, 2011, we executed a standby letter of credit of \$1.5 million in connection with the lease of our new Seattle offices and reserved this amount against the line of credit, which subsequently reduced the available line to \$2.5 million. As of September 30, 2011, there were no other amounts outstanding under the line of credit.

***We expect our results of operations to fluctuate on a quarterly and annual basis.***

Our revenue and results of operations could vary significantly from period to period and may fail to match expectations as a result of a variety of factors, some of which are outside our control. The other risk factors discussed in this Risk Factors section may contribute to the variability of our quarterly and annual results. In addition, our results may fluctuate as a result of fluctuations in the quantity of, and the price at which we are able to sell, our remnant advertising and the size and seasonal variability of our advertisers' marketing budgets. As a result of the potential variations in our revenues and results of operations, period-to-period comparisons may not be meaningful and the results of any one period

## Edgar Filing: ZILLOW INC - Form 10-Q

should not be relied upon as an indication of future performance. In addition, our results of operations may not meet the expectations of investors or public market analysts who follow us, which may adversely affect our stock price.

## **Table of Contents**

### **Risks Related to Ownership of Our Class A Common Stock**

*Our stock price may be volatile, and the value of an investment in our common stock may decline.*

Shares of our Class A common stock were sold in our initial public offering on July 20, 2011 at a price of \$20.00 per share. We cannot predict the extent to which investor interest in us will lead to the development of an active trading market, or how liquid that market might become. An active public market for our Class A common stock may not develop or be sustained. If an active public market does not develop or is not sustained, it could depress the trading price of our Class A common stock.

The market price of our Class A common stock could be subject to wide fluctuations in response to many of the risk factors discussed in this Quarterly Report on Form 10-Q and others beyond our control, including:

actual or anticipated fluctuations in our financial condition and results of operations;

changes in projected operational and financial results;

addition or loss of significant customers;

actual or anticipated changes in our growth rate relative to that of our competitors;

announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital-raising activities or commitments;

announcements of technological innovations or new offerings by us or our competitors;

additions or departures of key personnel;

changes in laws or regulations applicable to our services;

fluctuations in the valuation of companies perceived by investors to be comparable to us;

issuance of new or updated research or reports by securities analysts;

sales of our Class A common stock by us or our shareholders;

stock price and volume fluctuations attributable to inconsistent trading volume levels of our shares;

the expiration or waiver of contractual lock-up provisions; and

general economic and market conditions.

Furthermore, the stock markets in recent years have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of the equity securities of many companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political and market conditions such as recessions, interest rate changes or international currency fluctuations, may negatively impact the market price of our Class A common stock. If the market price of our Class A common stock declines, you may not realize any return on your investment in us and may lose some or all of your investment. In the past, companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert management's attention from other business concerns, which could harm our business, results of operations or financial condition.

***The dual class structure of our common stock as contained in our charter documents has the effect of concentrating voting control with our founders, and limits your ability to influence corporate matters.***

Since Zillow's inception, our capital structure has had authorized Class A common stock and authorized Class B common stock. Our Class A common stock has one vote per share, and our Class B common stock has 10 votes per share. All shares of Class B common stock have been and are held by our founders, Richard Barton and Lloyd Frink. As of September 30, 2011, Mr. Barton's holdings and Mr. Frink's holdings represented approximately 46.4% and 37.6%, respectively, of the voting power of our outstanding capital stock.

Therefore, for the foreseeable future, Mr. Barton and Mr. Frink will have significant control over our management and affairs and will be able to control all matters requiring shareholder approval, including the election or removal (with or without cause) of directors and approval of any significant corporate transaction, such as a merger or other sale of us or our assets. This concentrated control could delay, defer or prevent a change of control, merger, consolidation, takeover or other business combination involving us that you, as a shareholder, may otherwise support. This concentrated control could also discourage a potential investor from acquiring our Class A common stock due to the limited voting power of such stock relative to the Class B common stock and might harm the market price of our Class A common stock.

***Future sales of our Class A common stock in the public market could cause our stock price to decline.***

Sales of a substantial number of shares of our Class A common stock in the public market, or the perception that such sales might occur, could depress the market price of our Class A common stock and could impair our ability to raise capital through the sale

---

**Table of Contents**

of additional equity securities. Of our 18,029,698 shares of Class A common stock outstanding and 9,528,313 shares of Class B common stock outstanding as of September 30, 2011, all of the shares of Class A common stock sold in our initial public offering are freely tradable, except that (1) any shares held or acquired by our affiliates, as that term is defined in Rule 144 under the Securities Act of 1933, as amended, or the Securities Act, are subject to the volume limitations and certain other restrictions of Rule 144 and (2) any shares purchased through the directed share program are subject to a 180-day lock-up. The shares of our Class A common stock sold in the concurrent private placement are subject to the holding period requirements of Rule 144 and are, therefore, subject to a minimum six-month holding requirement before such shares can be sold in a non-registered transaction. Of our shares of Class A common stock outstanding as of September 30, 2011, 14,188,648 shares are restricted as a result of securities laws, lock-up agreements or other contractual restrictions that restrict transfers until January 15, 2012, subject to certain extensions and subject to certain earlier releases if certain conditions are met. In addition, the lead underwriter of our initial public offering may, in its sole discretion, release all or some portion of the shares subject to lock-up agreements prior to expiration of the lock-up period. As of September 30, 2011, the holders of 10,885,085 shares of Class A common stock and 9,528,313 shares of Class B common stock, or 74.1% of our total outstanding Class A common stock (calculated on an as-if-converted basis), will be entitled to rights with respect to registration of these shares under the Securities Act pursuant to an investors' rights agreement. If the holders of our Class A common stock and Class B common stock entitled to registration rights elect to exercise such rights and sell a large number of shares, they could adversely affect the market price of our Class A common stock. If we file a registration statement for the purposes of selling additional shares to raise capital and are required to include shares held by these holders pursuant to the exercise of their registration rights, our ability to raise capital may be impaired. On August 5, 2011, we filed a registration statement on Form S-8 under the Securities Act to register 6,816,135 shares of our Class A common stock for issuance under our 2005 Plan and 2011 Plan. Shares of our Class A common stock issued under the S-8 can be freely sold in the public market when the options underlying the shares are exercised, subject to the lock-up period and other restrictions provided under the terms of the applicable plan, option agreements or lock-up agreements entered into with the option holders.

***If securities or industry analysts do not publish research or publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.***

The trading market for our Class A common stock will depend in part on the research and reports that securities or industry analysts publish about our company. If few or no securities or industry analysts cover our company, the market price of our Class A common stock could be negatively impacted. If securities or industry analysts cover us and if one or more of such analysts downgrades our Class A common stock or publishes inaccurate or unfavorable research about our business, our stock price would likely decline. If one or more of the analysts covering us fail to publish reports on us regularly, demand for our Class A common stock could decline, which could cause our stock price and trading volume to decline.

***The requirements of being a public company may strain our resources and distract our management, which could make it difficult to manage our business.***

We are required to comply with various regulatory and reporting requirements, including those required by the SEC. Complying with these reporting and other regulatory requirements can be time-consuming and results in increased costs to us and could harm our business, results of operations and financial condition.

As a public company, we are subject to the reporting requirements of the Exchange Act. These requirements could strain our systems and resources. The Exchange Act requires that we file annual, quarterly and current reports with respect to our business and financial condition. The Exchange Act requires that we maintain effective disclosure controls and procedures and internal control over financial reporting. To maintain and improve the effectiveness of our disclosure controls and procedures and internal control over financial reporting, we have committed significant resources, hired additional staff and provided additional management oversight. We have implemented additional procedures and processes for the purpose of addressing the standards and requirements applicable to public companies. Sustaining our growth will require us to commit additional management, operational and financial resources to identify new professionals to join us and to maintain appropriate operational and financial systems to adequately support expansion. These activities may divert management's attention from other business concerns and could make it difficult to manage our business, which could harm our business, results of operations, financial condition and cash flows. In addition, if we find any material weakness in our internal control, we could lose investor confidence in the accuracy and completeness of our financial reports, which would cause the market price of our Class A common stock to decline.

***Anti-takeover provisions in our charter documents and under Washington law could make an acquisition of us more difficult, limit attempts by shareholders to replace or remove our management and affect the market price of our Class A common stock.***

Provisions in our articles of incorporation and bylaws, as amended and restated, may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated articles of incorporation or amended and restated bylaws include provisions, some of which will become effective only after the date, which we refer to as the threshold date, on which the Class B common stock controlled by our founders represents less than 7% of the aggregate number of shares of the outstanding Class A common stock and Class B common



stock, that:

set forth the dual class structure of our common stock, which concentrates voting control of matters submitted to a vote of our shareholders with the holders of our Class B common stock, which is held by our founders;

**Table of Contents**

authorize our board of directors to issue, without further action by our shareholders, up to 30,000,000 shares of undesignated preferred stock, subject, prior to the threshold date, to the approval rights of our holders of Class B common stock;

establish that our board of directors will be divided into three classes, Class I, Class II and Class III, with each class serving three-year staggered terms;

prohibit cumulative voting in the election of directors;

provide that, after the threshold date, our directors may be removed only for cause;

provide that, after the threshold date, vacancies on our board of directors may be filled only by the affirmative vote of a majority of directors then in office or by the sole remaining director;

provide that only our board of directors may change the size of our board of directors;

specify that special meetings of our shareholders can be called only by the chair of our board of directors, our board of directors, our chief executive officer, our president or, prior to the threshold date, holders of at least 25% of the combined voting power of our outstanding Class A common stock and Class B common stock;

establish an advance notice procedure for shareholder proposals to be brought before a meeting of shareholders, including proposed nominations of persons for election to our board of directors;

require the approval of our board of directors or the holders of two-thirds of the voting power of our outstanding Class A common stock and Class B common stock, voting together as a single group, to amend or repeal our bylaws; and

require the approval of two-thirds of the outstanding voting power of our Class A common stock and Class B common stock, voting together as a single group, to amend certain provisions of our articles of incorporation.

Prior to the threshold date, our directors can be removed with or without cause by holders of our Class A common stock and Class B common stock, voting together as a single group, and vacancies on the board of directors may be filled by such shareholders, voting together as a single group. Given the dual class structure of our common stock, our founders, Richard Barton and Lloyd Frink, who hold our Class B common stock, will have the ability for the foreseeable future to control these shareholder actions. See the risk factor above titled "The dual class structure of our common stock as contained in our charter documents has the effect of concentrating voting control with our founders and limits your ability to influence corporate matters."

The provisions described above, after the threshold date, may frustrate or prevent any attempts by our shareholders to replace or remove our current management by making it more difficult for shareholders to replace members of our board of directors, which is responsible for appointing our management. In addition, because we are incorporated in the State of Washington, we are governed by the provisions of Chapter 23B.19 of the Washington Business Corporation Act, which prohibits certain business combinations between us and certain significant shareholders unless specified conditions are met. These provisions may also have the effect of delaying or preventing a change of control of our company, even if this change of control would benefit our shareholders.

**Table of Contents**

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

Concurrent with the closing of the IPO, on July 25, 2011, we completed a private placement offering to funds affiliated with Technology Crossover Ventures and PAR Investment Partners, L.P., for 274,999 shares of our Class A common stock at a price of \$20.00 per share.

On July 25, 2011, we sold and issued 3,981,300 shares of our Class A common stock, including 519,300 shares of Class A common stock pursuant to the underwriters' option to purchase additional shares, at a public offering price of \$20.00 per share. The aggregate gross proceeds for all shares sold by us in the IPO were \$79,626,000. The offer and sale of all of the shares in the IPO were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-173570), which was declared effective by the SEC on July 19, 2011, and a prospectus filed pursuant to Rule 424(b) of the Securities Act.

There has been no material change in the planned use of proceeds from our IPO as described in our final prospectus filed with the SEC pursuant to Rule 424(b).

**Table of Contents****Item 6. Exhibits**

The exhibits listed below are filed as part of this Quarterly Report on Form 10-Q.

Exhibit Number	Description
31.1	Certification of Chief Executive Officer Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer Pursuant to Rule 13-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

\* Users of this data are advised that, pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Exchange Act of 1934 and otherwise are not subject to liability.

**Table of Contents**

**SIGNATURES**

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

Dated: November 4, 2011

**ZILLOW, INC.**

By: /s/ CHAD M. COHEN

Name: Chad M. Cohen

Title: Chief Financial Officer and Treasurer (Principal

Financial and Accounting Officer) and Duly

Authorized Signatory