MARCHEX INC
Form 10-K
March 16, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

or

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

For the transition period from_______ to _______.

Commission File Number 000-50658

Marchex, Inc.

(Exact name of Registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**35-2194038** **(I.R.S Employer** **Identification No.)**

413 Pine Street, Suite 500, Seattle, Washington 98101

(Address of principal executive offices, including zip code)

Registrant s telephone number, including area code: (206) 331-3300

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
Class B Common Stock, $0.01 par value per share	**The NASDAQ Stock Market LLC**
Preferred Stock, $0.01 par value per share	

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was approximately $396,969,600 as of June 30, 2006 based upon the closing sale price on the Nasdaq Global Market reported for such date. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

There were 11,659,216 shares of the registrant s Class A common stock issued and outstanding as of March 12, 2007 and 30,248,568 shares of the registrant s Class B common stock issued and outstanding as of March 12, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement for the 2007 Annual Meeting of Stockholders are incorporated herein by reference in Part III of this Annual Report on Form 10-K to the extent stated herein.

TABLE OF CONTENTS

Table of Contents

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes , intends , expects , anticipates , plans , may , will and similar expressions to identify forward-looking statements. Discussions containing forward-looking statements may be found in the material set forth under Business, Management s Discussion and Analysis of Financial Condition and Results of Operations and in other sections of the report. All forward-looking statements, including, but not limited to, statements regarding our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described in Item 1A of this Annual Report on Form 10-K under the caption Risk Factors and elsewhere in this report. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

PART 1

ITEM 1. BUSINESS.

Overview

References herein to we , us or our refer to Marchex, Inc. and its wholly-owned subsidiaries unless the context specifically states or implies otherwise.

We are a technology driven search and media company focused on vertical and local online traffic. Specifically, we focus on search marketing, local search, and direct navigation. Our platform of integrated performance-based advertising and search marketing services enables merchants to efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and selected Web sites.

We offer advertiser technology services that allow us to aggregate merchants of different profiles, ranging from small local businesses to large enterprises. Our merchant advertiser technology services include: feed management, bid management, contextual targeting, pay-per-click targeting, natural search optimization; and outsourced search marketing platforms, which is a combination of many of our advertiser technology services that we provide to super-aggregator partners and publishers to allow them to sell search marketing packages directly to their customers. We have a broad network of online distribution for our merchant advertisers products that consist of: (1) a partner network, which are publishers that want our merchants products or advertisements which they can promote on their network or Web site(s); and (2) a proprietary network, which is traffic that comes to Web sites we own. Our partner network includes search engines, product shopping engines, and vertical Web sites, such as Google, Yahoo, Microsoft, Shopping.com, Shopzilla, BusinessWeek.com, Investors.com, The Motley Fool, the Ziff Davis Media Web sites, and others. Our proprietary network is comprised of more than 200,000 Web sites.

We believe we have characteristics that include: (1) owning proprietary, performance-based advertising technologies which merchants can leverage to efficiently market their products and services online; (2) owning

Table of Contents

proprietary online traffic, which allows merchants to reach targeted potential customers; and (3) offering a diverse network of partner online traffic sources, which allows merchants to reach a wide audience of potential customers.

We have a suite of technology-based products that facilitate and support the efficient and cost-effective marketing and selling of goods and services online through the most rapidly-developing online marketing methods, including search and contextual marketing. We accomplish this by providing multiple technology-based services to consumers and merchant advertisers:

Local and Vertical Web Sites. We have more than 200,000 vertical and local Web sites. Our Web sites are designed to help online users find information for specific products or services, and also find relevant advertisers who sell such products or services. We refer to this service as direct navigation.

Contextual Targeting. We sell advertising placement on specialized vertical and branded Web sites and on specific sections of a Web site advertising listings on a bid-for-click basis. We refer to this service as site-specific contextual advertising. We believe this site-specific approach to contextual advertising provides publishers with an opportunity to monetize the value of their own brand and traffic, and gives advertisers greater transparency and relevancy.

Pay-Per-Click Targeting. We deliver pay-per-click advertising listings that are reflective of our merchant advertisers products and services to online users in response to their keyword search queries, and in response to their typing of specific Web Sites into their browser (direct navigation). These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of search engines, product shopping engines, directories, certain third party Web sites and our portfolio of owned Web sites. We also generate revenue from cost-per-action services. Cost-per-action revenue occurs when the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to a merchant advertiser Web site and completes a specified action.

Natural Search Engine Optimization. We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

Outsourced Search Marketing Platforms. We support the online marketing efforts of local businesses and SMEs (small and medium-sized enterprises) by providing super-aggregator partners, such as yellow page publishers and newspaper companies, with an outsourced platform of our performance-based advertising and search marketing technology services. Our outsourced platform allows super-aggregator partners to directly sell search marketing packages to their customers, such as yellow page or classified advertisers. Our outsourced platform for publishers, which is separate and distinct from our local platform, allows publishers to monetize their Web sites(s) with their advertiser relationships. Our outsourced platforms are provided to super-aggregator partners and publishers allowing the partners and publishers to sell and maintain under their brand.

Feed Management. We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web s largest search engines, product shopping engines and directories.

Bid Management. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

We believe we are among the leaders in the direct navigation market as we own a proprietary base of more than 200,000 Web sites. Our Web sites can be categorized into more than 10 vertical commerce categories

Table of Contents

including: Auto, Business Services & Finance, Directory & Reference, Education & Careers, Electronics & Technology, Entertainment & Food, Personals, Professional Services, Real Estate & Home, Shopping, Travel and Zip Codes. The online user traffic is primarily monetized with pay-per-click listings that are relevant to the Web sites, as well as other forms of advertising, which may include banner placements or sponsorships. As such, the Web sites connect online users searching for specific information with relevant advertisements.

We intend to continue introducing products and services that will enable merchants to successfully acquire customers and transact online. While we currently provide performance-based advertising and search marketing technology services, in the future we may provide additional, complementary services. We also intend to increase our position in the local search market by continuing to support super-aggregator partners with our outsourced platform, which will provide more local merchants with the ability to market their products online. Additionally, we intend to focus on growing proprietary traffic sources that can drive potential customers to our merchants.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date and are a component of our overall strategy. We have completed the following acquisitions since inception:

On February 28, 2003, we acquired Enhance Interactive.

On October 24, 2003, we acquired TrafficLeader.

On July 27, 2004, we acquired goClick.

On February 14, 2005, we acquired certain assets of Name Development.

On April 26, 2005, we acquired certain assets of Pike Street Industries.

On July 27, 2005, we acquired IndustryBrains.

On May 1, 2006, we acquired certain assets of AreaConnect.

On May 26, 2006, we acquired certain assets of Open List.

Industry Overview

Performance-Based Advertising

As technology and the Internet continue to evolve, consumers are becoming increasingly confident that they can find comprehensive product information and securely transact online. As consumers spend more time and money online, advertisers are turning to the Internet to market their products and services. According to comScore Networks, consumer online non-travel (retail) spending at U.S. sites during 2006 reached $102.1 billion, a 24% increase versus 2005. We believe that businesses of all sizes can benefit from the Internet s potential to efficiently and cost-effectively reach consumers. According to the Small Business Administration Office of Advocacy s Report to the President on the small-business economy, the number of small businesses alone in the United States was more than 25 million in 2005. We believe there is a large opportunity to sell online performance-based advertising services to businesses of all sizes. As a reflection of the potential impact of the Internet as an advertising medium, Morgan Stanley estimates that internet advertising spending in the United States will grow from approximately $16.0 billion in 2006 to $31.8 billion in 2010. Internet advertising enables merchant advertisers to measure the effectiveness of their advertising campaigns and to revise them in response to real-time feedback and market factors. Traditional forms of advertising are not as targeted and do not permit evaluation of results in as timely and accurate a manner.

Within the Internet advertising market, paid search has become one of the fastest growing sectors. Morgan Stanley estimates that paid search in the United States will grow 136% from $6.7 billion in 2006 to $15.8 billion in 2010. According to the Kelsey Group, only 17% of small and medium businesses in the United States currently utilize search marketing methods, but that number is expected to grow as more merchants experience the benefits. In addition, according to the Interactive Advertising Bureau (IAB) and PricewaterhouseCoopers (PwC), 47% of

Table of Contents

Internet advertising in the first half of 2006 was performance-based, as opposed to 40% in the first half of 2005. We believe that merchant advertisers are increasingly turning to performance-based online advertising for the following reasons:

- ***Competitive Return-On-Investment.*** Merchant advertisers have experienced competitive returns on their online advertising campaigns. As advertisers have analyzed their marketing programs, they have determined that they are able to pay more for their programs while still generating an acceptable return-on-investment. As a result, Morgan Stanley estimates that the average price-per-click in the United States will increase from $0.45 to in 2005 to $0.50 in 2010.

- ***Consumers Increasing Receptiveness to Performance-Based Advertising.*** Due to the relevancy and appropriate placement of advertisements, Morgan Stanley estimates that the rate at which consumers click through paid search advertisements will grow from 10.8% in 2005 to 12.6% in 2010.

Direct Navigation

Navigating and searching for information online has continued to evolve as users have become increasingly sophisticated. This continuing evolution has translated into a need for information providers to more efficiently provide highly-targeted, relevant information. Currently, there are three primary means through which online users access and search for information, products and services: search engines, commerce portals and direct navigation Web sites. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources.

Morgan Stanley estimates that the United States paid search market will reach $8.6 billion in revenue in 2007, and we believe the direct navigation market currently represents 10% or more of the paid search market and is growing at comparable annual rates. According to WebSideStory, Inc. s StatMarket division, in September 2004 more than 67% of daily global Internet users arrived at Web sites by direct navigation (defined as typing a URL into a browser address bar or using a bookmark) rather than through search engines and Web links, compared to approximately 53% in February 2002. The growth of the direct navigation market is a result of consumers increasing sophistication in utilizing the Internet as a resource tool, coupled with their desire to quickly find targeted information, and their trust and experience that the depth and breadth of available and relevant online information extends to Web sites named by descriptive keywords. Direct navigation and the use of search engines, however, are not mutually exclusive. We believe that many of the commercially relevant Web sites which we own may be beneficiaries of search engine and directory traffic over time.

Strategy

We intend to leverage our senior management s experience, our financial and human resources and our existing operations to provide technology-based merchant services that facilitate and drive growth in online transactions. Key elements of our strategy include the following initiatives:

- ***Increase Proprietary Traffic through Extending Presence in the Direct Navigation Market.*** We are in the process of implementing numerous initiatives to increase the traffic and monetization of our network of Web sites, including: (1) enhancing the utility of the Web sites by leveraging our search technology to publish relevant information to them; (2) broadening our geographic presence; (3) making selective purchases of complementary Web sites; and (4) selective marketing.

- ***Provide Quality Services in Support of Merchants and Partners.*** We believe providing high quality services will make us more valuable to our merchants and partners. We are building products and services that we believe are innovative and provide a high degree of utility. We intend to continue investing our resources to create or develop new products, technologies and business models. We intend to expand our services by providing systems and information that help merchant advertisers maximize the performance of online marketing budgets and by working with partners to develop and market new products.

Increase the Number of Merchants Served. We believe we will continue to grow our base of merchant advertisers and strive to build merchant loyalty by providing merchants with a consistently high level of service and support as well as the ability to achieve their target return-on-investment thresholds. We intend to increase the number of merchants served through:

- direct sales efforts, including strategic sales and telesales initiatives;
- referral arrangements with entities that can promote our services to potential merchants, such as advertising agencies; and
- partnerships with large aggregators of advertisers, such as regional yellow page companies.

Develop New Markets. We intend to analyze opportunities and may seek to expand our technology-based services into new categories or new geographic areas where our services can be replicated on a cost effective basis, or where the creation or development of a service may be appropriate. We anticipate utilizing various strategies to enter new markets, including: developing strategic relationships; acquiring products that address a new category or opportunity; acquiring country-specific properties; and creating joint venture relationships and internal initiatives where existing services can be extended internationally.

Pursue Selective Acquisition and Consolidation Opportunities. We plan to selectively pursue strategic acquisitions. We apply rigorous evaluation criteria to acquisitions that are intended to enhance our strategic position, strengthen our financial profile, augment our points of defensibility and increase shareholder value. We do this through focusing on acquisition opportunities that represent a combination of the following characteristics:

- under-leveraged and under-commercialized assets;
- opportunities for business model, product or service innovation and evolution;
- critical mass of transactions volume, merchants, traffic, revenue and profits;
- business defensibility;
- revenue growth and expanding margins and operating profitability or the characteristics to achieve significant scale and profitability; and
- an opportunity to enhance efficiencies and provide incremental growth opportunities for our operating businesses.

Our Services

Through our suite of search marketing services, we have partnered with a diverse set of Internet traffic partners in order to provide our merchant advertisers with access to a large base of potential, targeted customers. Our distribution strategy has been focused on building a broad footprint with primary online traffic sources, including search engines, product shopping engines, vertical Web sites, and local Web sites. Additionally, we have focused on developing services and technologies to expand the suite of search-based marketing products we provide to online merchant advertisers. We believe that offering a holistic approach to search engine marketing services enables us to extend our reach to a broad base of customers and offer solutions that can generally address all the needs of a customer interested in search marketing.

Table of Contents

Our services are used to support and build the businesses of our merchant advertisers. We enable merchants to market and sell their products and services online through the following technology-based services:

Service	**Description**
Performance-Based Advertising Services	Performance-based advertising services enable merchants to reach their target audience through search, product shopping and directory results. Contextual targeting. With contextual targeting services, the amount that a merchant advertiser pays for the click-through and the relevance of its advertisement based on historical click-through rates, influences the rank of its listings within the applicable results set. Pay-per-click targeting. With pay-per-click targeting services, the amount that a merchant advertiser pays for the click-through influences the rank of its listings within the applicable results set. With cost-per-action services, the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to a merchant advertiser Web site and completes the specified action. Feed management. With feed management services, the ranking of a merchant advertiser s listing is influenced by the relevance of the product or service in relation to the user search query.
Search Marketing Services	Search marketing services are designed to assist merchant advertisers who want to acquire customers through search-based marketing methods, optimize the performance of their online advertising campaigns by tracking and analyzing historical results and refine their Web sites for increased relevance in algorithmic search engine indexes. Bid management. Bid management services enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of their online advertising campaigns using our conversion tracking and detailed reporting services. Natural search engine optimization. Natural search engine optimization services enable merchant advertisers to optimize key attributes of their Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.
Outsourced Search Marketing Platforms	Outsourced search marketing platforms for local search services and web publishers are designed to enable super-aggregator partners and publishers with an outsourced, integrated search management platform to market performance-based advertising and search marketing services to their customers.

During the periods ended December 31, 2004, 2005, and 2006, performance-based advertising services comprised approximately 95%, 94%, and 92%, respectively, of our total revenue. As we continue to develop our services and implement new technologies and services, we believe the breadth of our marketing solutions will lead to cross-leverage through technical integration. The Company operates principally in domestic markets. For revenues by merchant advertisers by geographical areas for the three last fiscal years, see Note 1(q) Segment Reporting and Geographic Information of the notes to our consolidated financial statements.

Table of Contents

Performance-Based Advertising Services

Merchant advertisers utilize our performance-based advertising services to reach millions of individuals and businesses who search online for information on products and services. According to a PricewaterhouseCoopers April 2004 report, performance-based advertising is one of the most rapidly growing segments of Internet advertising, as it is one of the most efficient and effective means to generate competitive returns-on-investment for advertisers. Accordingly, we are building appropriate services to leverage this trend.

On any given search engine results page, the listings that appear can either be categorized as sponsored listings or editorial listings. By leveraging the combination of our pay-per-click and feed management performance-based advertising services, merchant advertisers can ensure the broadest coverage within a given results page in response to a user search query, since our pay-per-click management service ensures merchant advertisement appearance within sponsored listings, and our feed management service ensures merchant advertisement appearance within editorial listings. The following is a description of our performance-based advertising services:

Contextual Targeting. Our contextual targeting service enables merchant advertisers to market their products and services through targeted pay-per-click listings that we distribute through vertically-focused Web sites or specific pages of a Web site. Our services enable merchants to purchase keywords or keyword strings, based on an amount they choose for a targeted placement, that are specific to their products and services and their marketing objectives.

We believe contextual targeting services are an important complement to pay-per-click, algorithmic search and feed management technologies as they enable merchants to place relevant listings on relevant vertically-focused Web sites. This process has the dual benefit of: (1) enhancing the user experience by placing relevant targeted listings at the portion of a Web page dedicated to sponsored listings; and (2) connecting merchant advertisers with targeted customer leads.

The contextual results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant s advertisement and the relevance of the merchant s advertisement, based on historical click-through rates. Merchant advertisers pay us when a click-through occurs on their advertisement.

Pay-Per-Click Targeting. Our pay-per-click services enable merchant advertisers to market their products and services through targeted pay-per-click listings that we distribute through search engine or directory results when a user searches for information, products or services. We provide our services to thousands of merchant advertisers who want to drive customer leads to their Web sites. Our services enable merchants to purchase keywords or keyword strings, based on an amount they choose for a targeted placement, that are specific to their products and services and their marketing objectives. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from one of our Web sites or a third-party Web site included in our distribution network to a merchant advertiser Web site and completes the specified action.

We believe that pay-per-click services are an important complement to algorithmic search and feed management technologies as they enable merchants to place relevant listings on a search engine results page related to a specific user information request.

When merchant advertisers submit advertisement listings to our service, we assist merchant advertisers in optimizing their advertisement campaigns by recommending relevant keywords or keyword strings based on their Web sites and product or service offerings.

The pay-per-click results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant s advertisement. Merchant advertisers pay us when a click-through occurs on their advertisement.

Table of Contents

Merchant advertisers find us directly through our Web sites and through contact with our sales force, and we find merchant advertisers through direct sales efforts, through third-party referral programs and through a variety of marketing activities that include trade shows, sponsorships, targeted mailings, online advertisements, e-mails and other promotional materials sent directly to merchant advertisers, advertising agencies and search engine marketers.

Feed Management. Our feed management services deliver targeted advertiser listings into some of the Internet s most visited search engines and product shopping engines. Feed management leverages our proprietary technology to crawl and extract relevant product data and content from a merchant advertiser database and Web site, and to create highly relevant, optimized URL strings and advertisement listings. Increased listing relevancy frequently translates into a better search experience for users, allowing them to find targeted results in response to their search queries, and a competitive return-on-investment for merchant advertisers, as higher relevance typically leads to increased click-through and conversion rates, or customer acquisitions.

Once our technology has crawled, extracted, optimized and refined the merchant advertiser URL strings and advertisement listings, such strings and listings are tagged and placed into partner search and directory indexes. These URL strings and listings map directly to user search queries that link back to specific product pages when clicked, which we believe typically leads to competitive advertiser conversion rates.

We believe that most algorithmic search engines crawl the Web approximately every seven to fourteen days. When a merchant s Web site is crawled by algorithmic technology, many product and service listings tend to be excluded due to the nature of most merchant advertisers product databases, which contain complex structures and are dynamically updated. Our trusted feed relationships with our distribution partners allow us to deliver every merchant advertiser s product and to provide updated content in frequent intervals, as we regularly refresh the listings with the most up-to-date information. This is a significant benefit for our merchant advertisers as we maximize the number of selling opportunities and for our distribution partners as we increase the relevance of a user search experience.

We believe that feed management is an important complement to algorithmic search technologies since merchant advertisers provide us with direct access to their internal product databases. Often, only once a feed management service has crawled, replicated and optimized hundreds or thousands of individual product and informational Web pages for a merchant advertiser do links to these pages appear within search engine results. We believe the indexing and subsequent listing of these Web pages made possible by feed management enhances the overall relevancy of the search engines with which the Company partners. We also believe feed management is complementary to pay-per-click services as merchants: (1) can leverage our technology to create detailed listings for each of their products; and (2) can leverage our extensive keyword query string database to identify many relevant keyword listings often overlooked in the manual pay-per-click listing creation process.

Merchant advertiser URL strings and advertisement listings are typically ordered based on relevance to the user search query. Merchant advertisers generally pay us a fixed price for each click received on each URL string and advertisement listing.

Additionally, by leveraging proprietary technology, we can analyze an advertiser s database as well as thousands to millions of actual, relevant user search queries to create additional, unique merchant advertiser listings that drive targeted traffic resulting in competitive conversion, or customer acquisition, rates. These additional unique listings are generally included as part of our basic feed management service.

Search Marketing Services

Our search marketing services are designed to assist merchant advertisers who want to acquire customers through search-based marketing methods, optimize the performance of their online advertising campaigns through tracking and analyzing historical results and refine their Web sites for increased relevance in algorithmic search engine indexes. The following is a description of our search marketing services:

Bid Management. Through our advertising campaign management services, merchant advertisers continuously track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks and track the effectiveness of their online advertising campaigns. Our bid management services allow our merchant advertisers to consolidate the purchasing, management, optimization and reporting aspects of performance based search advertising campaigns. We have partnerships with leading search and product shopping engines that allow us to place and manage our clients paid listings directly within their account management systems. Additionally, we provide detailed reporting services that enable merchants to track the effectiveness of their online advertising campaigns through conversion tracking and detailed reporting tools. By developing a common technology architecture underneath our platform of search marketing services, we are able to analyze the effectiveness of our merchant partners advertising campaigns across a wide array of services and provide detailed reporting, such as: revenue per month statistics, number of orders, average order size and conversion rate and revenue by keyword and by distribution source.

Our bid management services broaden the potential reach of a merchant s advertising campaign by including multiple distribution partners as options for bid placement. Merchant advertisers pay us a pre-negotiated rate when a click through occurs on their advertisement. Also, with our analytic tool set, merchants are effectively able to track the effectiveness of their online advertising campaigns through the use of conversion tracking and analytic services.

Natural Search Engine Optimization. Our natural search engine optimization technology optimizes key attributes of merchant advertisers Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines. By leveraging our experience in the search industry and relationships with search engine distribution partners, we have architected a flexible technology platform that is designed to enable us to efficiently optimize our merchant partner Web sites in order to meet the ever changing technical standards of our distribution partners.

We primarily attract merchant advertisers with product databases who want to increase their online sales and achieve targeted return-on-investment metrics. Potential merchant advertisers find our services and we find them through a variety of means, including contact by our direct sales staff, through marketing efforts such as trade shows or advertising, and through third-party referral programs. Merchant advertisers pay us fees to optimize their site for inclusion in algorithmic search results.

Outsourced Search Marketing Platforms

We offer an outsourced solution for strategic partners who have several hundred to several thousand direct merchant relationships. As part of our search management services, we can enable a strategic partner, aggregator of merchant partner relationships or publisher with all or part of our suite of search marketing services. For example, we currently enable major regional yellow page publishers with our advertising campaign management and feed management services which they can market to their local online yellow page merchants.

Partners can leverage this service in one of two ways, including: (1) as a fully outsourced solution, in which we manage and fulfill search marketing campaigns, and also deliver reporting on behalf of our partners; or (2) as a Web-based solution that allows aggregators or publishers to implement and manage campaigns directly. We principally receive payment for our outsourced search marketing services through a combination of variable licensing fees associated with total revenue generated using our technology platform, flat rate licensing fees for the use of our technology platform and per-click payments for clicks delivered from our pay-per-click and feed management network.

Our Distribution Network

We have built a broad distribution network for our marketing services comprised of many of the leading search engines, product shopping engines, directories, certain third-party Web sites and our portfolio of owned Web sites. With the Name Development asset acquisition of more than 100,000 Web sites in 2005, our proprietary source of direct navigation traffic includes over 200,000 Web sites.

Table of Contents

Performance-Based Advertising Distribution

We distribute merchant advertisement listings and advertiser URL strings through hundreds of traffic sources, including search and product shopping engines, directories and Web sites. Distribution sources for our marketing services platform include:

Selected Search Engines	Selected Product Shopping Engines	Selected Vertical and Local Web Sites
Ask	Become.com	Bank Rate
Google	CNet s MySimon	BusinessWeek.com
LookSmart	Gifts.com	Food & Wine
Microsoft	Google s Froogle.com	Investors.com (Investors Business Daily)
Yahoo!	MSN Shopping	Kiplinger
	NexTag	SmartMoney
	PriceGrabber.com	The Motley Fool
	ShopLocal	TheStreet.com
	Shopping.com	The Ziff Davis Media Web sites
	Shopzilla	USAToday
	Yahoo! Shopping	

Yahoo! Search Marketing is our largest distribution partner and delivers traffic to our merchant listings which collectively represents approximately 7% of our total revenue for the year ended December 31, 2006. Separately, Yahoo! Search Marketing was responsible for 29% of our total revenue during the same period principally in respect of the revenues associated with our portfolio of domains.

Payment arrangements with our distribution partners are often subject to minimum payment amounts per click-through. Other economic structures that we may use to a lesser degree include:

- advance or fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid click-throughs; and
- a combination arrangement with both fixed and variable amounts.

Direct Navigation Distribution

We believe we are among the leaders in the direct navigation market due to our proprietary ownership of online user traffic, which totaled more than 31 million unique visitors in the month of December 2006. Unique visitor statistics are based on internal traffic logs, which calculate unique IP (Internet protocol) addresses on an unduplicated basis during a given month. This user traffic is generated from a portfolio of Web sites that are generally reflective of commercially-relevant search terms in many of the Internet s most popular and dynamic vertical commerce categories and also include geographically-targeted elements. The total number of Web sites we own is more than 200,000. These vertical commerce categories include: Auto, Business Services & Finance, Directory & Reference, Education & Careers, Electronics & Technology, Entertainment & Food, Personals, Professional Services, Real Estate & Home, Shopping, Travel, and Zip Codes. The online user traffic is primarily monetized with pay-per-click listings and graphical ad units that are relevant to the Web sites. As such, the Web sites connect online users searching for specific information with relevant advertisements.

Online users can navigate the Web sites through a number of ways. For example, an online user who is specifically interested in traveling to Beijing may enter *www.beijing.com* directly into the Web address or URL box of their Internet browser. Once the user has arrived at the Web site they will find listings and information related to Beijing. As the user finds relevant information and clicks on a particular listing, we receive a pay-per-click fee.

Table of Contents

The following represents a sampling of our Web sites and their corresponding vertical commerce category:

Vertical Commerce Category	Web Site Examples
Auto	Airbag.com Autolender.com Luxurycar.com Motorscooter.com Monstertrucks.com Pickup.com
Business Services & Finance	Angelfunding.com Corporations.com Debts.com Homelenders.com Loanconsolidation.com Refinancing.com
Directory & Reference	Areaconnect.com Moviedirectory.com Openlist.com Phonenumbers.com Searchlocal.com Yellow.com
Education & Careers	Bayareajobs.com Collegeguide.com GED.com Instruct.com Miamijobs.com Trigonometry.com
Electronics & Technology	3G.com Extranet.com

	Camcorders.com PBX.com Textmessaging.com Videocamera(s).com
Entertainment & Food	Burrito.com Cuisine.com Frenchrestaurants.com Invitation.com Moviedownload.com Salsa.com Sushibar.com
Personals	Friendsonline.com Matchmaking.com Matrimony.com Singleparent.com Weddingceremony.com Weddingreceptions.com

11

Table of Contents

Vertical Commerce Category	Web Site Examples
Professional Services	Bostonmortgage.com Eyesurgeons.com Exterminator.com Locksmiths.com Podiatrist.com Seattleinsurance.com
Real Estate & Home	Coffeetable(s).com Kitchensink.com LawnFurniture.com Ovens.com Recliners.com Remodeling.com
Shopping	Briefcases.com Childrensclothes.com Gymbag.com Luxurybags.com Moneyclip.com Necklaces.com
Travel	Aspenresort.com Bayareahotels.com Beijing.com Destination.com Lasvegasvacations.com Tourguide.com
Zip Codes	Myzip.com 90210.com 20016.com 94123.com

60614.com

10013.com

Sales, Marketing & Business Development

As of December 31, 2006, we had 51 full-time employee equivalents in our sales department, 10 full-time employee equivalents in our business development department and 9 full-time employee equivalents in our marketing department. Our sales department focuses on adding new merchant advertisers to our operating businesses, while our business development department focuses on servicing existing distribution partnerships and selectively adding new distribution partners. Our marketing department focuses on promoting our services through affiliate relationships, press coverage, and industry exposure. Advertising and promotion of our services is broken into five main categories: direct sales, agency sales, super aggregator sales, online promotion, and referral agreements.

Direct Sales. Our sales staff targets new merchant advertiser relationships through telesales efforts, direct marketing, and attendance at industry events.

Agency Sales. Our agency program includes a group within the sales team that targets interactive agencies and other entities that service merchant advertisers. This sales group focuses on in-person and remote presentations of our services to agencies, and is also periodically engaged in various marketing initiatives at industry trade shows and conferences. Our agency agreements may include a combination of revenue sharing, performance-based fees and other costs.

Super Aggregator Sales. Our super aggregator program includes a group within the sales team that targets large aggregators of merchant advertisers. An example of a large aggregator relationship would be our partnership with a large regional yellow page company whereupon we supply a comprehensive, outsourced search marketing platform that integrates our advertising campaign management and feed management platforms for their merchant advertisers. Our super aggregator agreements include a combination of revenue sharing, licensing revenue and per-click fees.

Online Promotion. We engage in certain advertising and direct marketing focused on acquiring new merchant advertisers and new distribution partners.

Referral Agreements. We seek to build referral arrangements with entities that can promote our services to large numbers of potential advertisers. Our referral partner agreements are based on a combination of revenue sharing and performance-based fees.

We intend to continue our strategy of growing our merchant advertiser base through sales and marketing programs while being as efficient as possible in terms of our marketing and advertising costs. We continually evaluate our marketing and advertising strategies to maximize the effectiveness of our programs and their return on investment.

Information Technology and Systems

We have a proprietary technology platform for the purposes of managing and delivering advertisements to our partners. We also combine third party licenses and hardware to create an operating environment that focuses on quality products and services, with such features as automated online customer purchasing, real-time customer support and interactive reporting for customers and partners. We employ commercially available technologies and products distributed by various companies, including Cisco, Dell, Oracle, Intel, Microsoft, Sun Microsystems and Veritas. We also utilize public domain software such as Apache, Linux, MySQL, Sun Microsystems Java and Tomcat.

Our technology platform is compatible with the systems used by our distribution partners, enabling us to deliver advertisement listings in rapid response to user queries made through such partners. We continue to build and innovate additional functionality to attempt to meet the quickly evolving demands of the marketplace. We devote significant financial and human resources to improving our merchant and partner experiences by continuing to develop our technology infrastructure. The cost of developing our technology solutions is included in the overall cost structure of our services and is not separately funded by any individual merchants or partners.

In order to maintain a professional level of service and availability, we primarily rely upon third parties to provide hosting services, including hardware support and service, and network monitoring at various domestic and international locations. Our servers are configured for high availability and large volumes of Internet traffic and are located in leased third-party facilities. Back-end databases make use of redundant servers and data storage arrays. We also have standby servers that provide for additional capacity as necessary. The facilities housing our servers provide redundant HVAC, power and Internet connectivity.

We continuously review ways to improve major aspects of our technology support and maintenance, including improving, upgrading and implementing business continuity plans, data retention initiatives, and backup and recovery processes.

Competition

Performance-Based Advertising

Many of our potential competitors, as well as potential entrants into our target markets, have longer operating histories, larger customer or user bases, greater brand recognition and greater financial, marketing and other resources than we have. Many current and potential competitors can devote substantially greater resources than we can to promotion, Web site and systems development. In addition, as the use of the Internet and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies relevant to our business strategy; and invest in or form joint ventures in categories or countries relevant to our business strategy; all of which could adversely impact our business. Any of these trends could increase competition, reduce the demand for any of our services and could have a material adverse effect on our business, operating results and financial condition.

We pursue a strategy that we believe allows us to work with most, if not all, of the relevant companies in our industry, even those companies that may be perceived as our competitors. We intend to continue with a strategy that allows us to consider and pursue business arrangements with most, if not all, of the relevant companies in our industry.

We provide our services to: (1) merchant advertisers who advertise online; (2) partners who provide a distribution network for online advertising; and (3) other intermediaries who may provide purchasing and/or sales opportunities, including advertising agencies, search engine marketing companies and search engine optimization companies. We depend on maintaining and continually expanding our network of partners and merchants to generate transactions online. As a result, we may work with, and compete with, those who:

- sell performance-based advertising or search marketing services to merchants;
- aggregate or optimize advertising inventory for distribution through search engines, product shopping engines, directories, Web sites or other outlets; or
- provide destination Web sites or other distribution outlets that reach end users or customers of the merchants.

The online advertising and marketing services industry is highly competitive. In addition, we believe that today s typical Internet advertiser is becoming more sophisticated in utilizing the different forms of Internet advertising, purchasing Internet advertising in a cost-effective manner, and measuring return-on-investment. The competition for this pool of advertising dollars has also put downward pressure on pricing points and online advertisers have demanded more effective means of reaching customers. We believe that these factors have contributed to the growth in performance-based advertising relative to certain other forms of online advertising and marketing, and as a result this sector has attracted many competitors.

Due to the long-term growth trends in online advertising, these competitors, real and potential, range in size and focus. Our competitors may include such diverse participants as small referral companies, established advertising agencies, inventory resellers, search engines, and destination Web sites. To some extent, we may compete with our business partners, as we do with all other types of advertising sales companies and agencies. To a more limited extent, we may also compete with traditional offline media such as television, radio and print and direct marketing companies, for a share of merchant advertisers total advertising budgets. Although we pursue a strategy that enables us to work with most, if not all, of our competitors, there are no guarantees that all companies will view us as a potential partner.

We are also affected by the competition among destination Web sites that reach users or customers of search services. While thousands of smaller outlets are available to customers, several large media and search engine companies, such as Google, Yahoo!, Microsoft and AOL, dominate online user traffic. The online search industry continues to experience consolidation of major Web sites and search engines, which has the effect of increasing the negotiating power of these parties in relation to smaller providers. The major destination Web sites and distribution providers may have leverage to demand more favorable contract terms, such as pricing, renewal and termination provisions.

Direct Navigation

The direct navigation market is primarily categorized into two parts: (1) Web site owners, which are the entities that own the Internet domain and potentially monetize it through performance-based integrations with

Table of Contents

third parties, including pay-per-click integrations; and (2) Web site monetization providers, which are companies that provide the monetization engine for Web site owners, including pay-per-click providers. We believe that the segment of the direct navigation market that directly owns and monetizes Internet domains with performance-based advertising is highly fragmented, and that, as a result of the Name Development, Pike Street, and AreaConnect asset acquisitions, we are among the leaders in this segment.

While the availability of a high quality portfolio of multiple Internet domain names is limited and difficult to attain, the barriers to entry in the direct navigation market are also low as the cost of registering an individual Internet domain name is not significant. We expect competition to intensify as more analysis is conducted on, and more companies enter, the direct navigation market. This could adversely affect our competitive position and relatively small market share in the direct navigation industry.

Intellectual Property and Proprietary Rights

We seek to protect our intellectual property through existing laws and regulations and by contractual restrictions. We rely upon trademark, patent and copyright law, trade secret protection and confidentiality or license agreements with our employees, customers, partners and others to help us protect our intellectual property.

Our technologies involve a combination of proprietary rights, owned and developed by us, commercially available software and hardware elements that are licensed or purchased by us from various providers, including Cisco, Dell, Oracle, Intel, Microsoft, Sun Microsystems and Veritas, and public domain software, such as Apache, Linux, MySQL, Sun Microsystems Java and Tomcat. We continue to develop additional technologies to update, supplement and replace existing components of the platform. We intend to protect these additional intellectual property rights through patent applications and trade secret enforcement.

Our policy is to apply for patents or for other appropriate statutory protection when we develop valuable new or improved technology. We currently do not have any registered patents. We have filed three patent applications with the U.S. Patent and Trademark Office for various aspects of our technologies and services, with the following titles, numbers and descriptions:

- US Provisional Patent Application Serial Number 60/504,963, of Horowitz et al., entitled Performance-Based Online Advertising System and Method, was filed on September 23, 2003, with subsequent non-provisional US Patent Application Number 10/947,384 filed on September 23, 2004, and which is currently pending. This patent application describes a system, method, and computer program product for implementing a performance-based online service for advertisers that provide the ability for advertisers to purchase various advertising products.

- US Provisional Patent Application Serial Number 60/523,688, of Horowitz et al., entitled Online Advertising System and Method, was filed on November 21, 2003, with subsequent non-provisional US Patent Application Number 10/992,366 filed on November 19, 2004, and which is currently pending. This patent application describes an online advertising system, method, and computer program product configured to present an advertiser with keyword-driven pricing for advertisements.

- US Nonprovisional Patent Application Serial Number 11/498,217, of Korman et al., entitled Method and System for Populating Resources Using Web Feeds, was filed August 1, 2006, and is pending. This patent application describes a method and system for identifying web feeds and the content of web feeds for inclusion in resources.

The status of any patent involves complex legal and factual questions. The scope of allowable claims is often uncertain. As a result, we cannot be sure that: (1) any patent application filed by us will result in a patent being issued; (2) that any patents issued in the future will afford adequate protection against competitors with similar technology; and (3) that the patents issued to us, if any, will not be infringed upon or designed around by others. Furthermore, the performance-based search advertising industry has been the subject of numerous patents and patent applications, which in turn has resulted in litigation. The outcome of this ongoing litigation or any future claims in this sector may adversely affect our business or financial prospects.

We have registered trademarks in the United States covering certain goods and services for Marchex, the Marchex Logo, Direct Search Inclusion, goClick.com, Sitewise, Enhance Interactive, and TrafficLeader. We have also applied for registration of OpenList in the United States. In addition, we have registered trademarks for Marchex in Australia, Canada, China, the European Union, Hong Kong, India, Japan, Republic of Korea, Russian Federation and Taiwan. We have also applied for registration of Marchex in a number of other foreign jurisdictions. We do not know whether we will be able to successfully defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries are uncertain and still evolving.

Regulation

The manner in which existing laws and regulations should be applied to the Internet in general, and how they relate to our businesses in particular, is unclear. A host of federal and state laws covering user privacy, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, financial market regulation, quality of products and services, computer trespass, spyware, adware, child protection and intellectual property ownership and infringement are potentially applicable to our business practices and the content offered by our Web link distribution partners.

In addition, we expect new laws and regulations directly applicable to our business practices to be adopted in the near future. Any such new legislation could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations, and could dampen the growth in Internet usage generally.

Several federal and state laws that could have an impact on our business practices and compliance costs have already been adopted:

- the Digital Millennium Copyright Act (DMCA) provides protection from copyright liability for online service providers that list or link to third party Web sites. We currently qualify for the safe harbor under the DMCA, however, if it were determined that we did not meet the safe harbor requirements, we could be exposed to copyright infringement litigation, which could be costly and time-consuming.

- the Children s Online Privacy Protection Act (COPPA) restricts the distribution of certain materials deemed harmful to children and impose limitations on the Web sites ability to collect personal information from minors. COPPA allows the Federal Trade Commission (FTC) to impose fines and penalties upon Web site operators whose sites do not fully comply with the law s requirements. Another child protection law, the Child Online Protection Act (COPA), was intended to restrict the distribution of certain materials deemed harmful to children. This law was struck down as unconstitutional, but a similar federal or state law might be reintroduced in the future.

- the Protection of Children from Sexual Predators Act requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.

- the Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act of 2003 establishes requirements for those who send commercial e-mail, spells out penalties for entities that transmit noncompliant commercial e-mail and/or whose products are advertised in noncompliant commercial e-mail and gives consumers the right to opt-out of receiving commercial e-mails. The FTC is authorized to enforce the CAN-SPAM Act. This law also gives the Department of Justice the authority to enforce its criminal sanctions. Other federal and state agencies can enforce the law against organizations under their jurisdiction, and companies that provide Internet access may sue violators as well.

- the Electronic Communications Privacy Act prevents private entities from disclosing Internet subscriber records and the contents of electronic communications, subject to certain exceptions.

Table of Contents

the Computer Fraud and Abuse Act and other federal and state laws protect computer users from unauthorized computer access/hacking, and other actions by third parties which may be viewed as a violation of privacy.

Michigan and Utah child protection laws, designed to protect children under the age of 18 from receiving adult content via e-mail and other electronic forms of communication (e.g., cell phones and instant messaging). Both Michigan and Utah have developed lists of minors e-mail addresses based on parents and guardians submissions. Once an address has been on a list for 30 days, Web publishers are prohibited from sending the address anything containing, or even linking to, advertising for a product or service that a minor is legally prohibited from purchasing or using, even if the owner of that address previously requested to receive the information. In addition, senders need to match their own mailing lists against the state registries on at least a monthly basis, for which they must pay both Michigan and Utah a per-address fee.

In addition, there are a large number of federal and state legislative proposals related to our business. It is not possible to predict whether, or when, such legislation might be adopted, and certain proposals, if adopted, could result in a decrease in user registrations and revenue.

We comply with existing law and intend to fully comply with all future laws and regulations that may govern our industry. We have dedicated internal resources and hired outside professionals who regularly establish, review and maintain policies and procedures to reduce the risk of noncompliance. Nevertheless, these laws may impose significant additional costs on our business or subject us to additional liability, if we failed to fully comply, even if such failure was unintentional.

The acquisition of Internet domain names generally is governed by Internet regulatory bodies, predominantly the Internet Corporation for Assigned Names and Numbers (ICANN). The regulation of Internet domain names in the United States and in foreign countries is subject to change. ICANN and other regulatory bodies could establish additional requirements for previously owned Internet domain names or modify the requirements for Internet domain names.

We post a privacy policy which describes our practices concerning the use and disclosure of any user data collected or submitted via our Web sites. Any failure by us to comply with posted privacy policies, Federal Trade Commission requirements or other federal, state or international privacy-related laws and regulations could result in governmental or regulatory investigations that could potentially harm our businesses, operational results and overall financial condition.

Employees

As of December 31, 2006, we employed a total of 283 full-time employee equivalents. We have never had a work stoppage, and none of our employees are represented by a labor union. We consider our employee relationships to be positive. If we were unable to retain our key employees or we were unable to maintain adequate staffing of qualified employees, particularly during peak sales seasons, our business would be adversely affected.

Web Site

Our web site, *www.marchex.com*, provides access, without charge, to our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such materials are electronically filed with the Securities and Exchange Commission. To view these filings, please go to our website and click on Investors and then click on SEC Filings .

ITEM 1A. RISK FACTORS

An investment in our Class B common stock or preferred stock involves various risks, including those mentioned below and those that are discussed from time to time in our other periodic filings with the SEC.

Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding our stock. There may be additional risks of which we are currently unaware, or which we currently consider immaterial. All of these risks could have a material adverse effect on our financial condition, our results of operations, and the value of our stock.

Risks Relating to Our Company

Our limited operating history makes evaluation of our business difficult.

We were formally incorporated in January 2003. We acquired Enhance Interactive in February 2003, TrafficLeader in October 2003 and goClick in July 2004. In February and April 2005, we completed the acquisitions of certain assets of Name Development and Pike Street Industries, respectively. In July 2005 we completed the acquisition of IndustryBrains. In May 2006 we completed the acquisition of certain assets of AreaConnect, LLC and Open List, Inc.

We have limited historical financial data upon which to base planned operating expenses or forecast accurately our future operating results. Further, our limited operating history will make it difficult for investors and securities analysts to evaluate our business and prospects. Our failure to address these risks and difficulties successfully could seriously harm us.

We have largely incurred net losses since our inception, and we may incur net losses in the foreseeable future.

We had an accumulated deficit of $6.1 million as of December 31, 2006. Our net expenses may increase based on the initiatives we undertake which for instance, may include increasing our sales and marketing activities, hiring additional personnel, incurring additional costs as a result of being a public company, and acquiring additional businesses. In addition, commencing January 1, 2006, we began expensing the fair value of stock options granted in connection with our adoption of the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R).

We are dependent on certain distribution partners, including Yahoo! and its subsidiaries, for distribution of our services, and we derive a significant portion of our total revenue through these distribution partners. A loss of distribution partners or a decrease in revenue from certain distribution partners could adversely affect our business. Yahoo! is also a significant customer.

A relatively small number of distribution partners currently deliver a significant percentage of traffic to our merchant listings. Yahoo! Search Marketing is our largest distribution partner and delivers traffic to our merchant listings which collectively represents approximately 7% of our total revenue for the year ended December 31, 2006. Separately, Yahoo! Search Marketing was responsible for 29% of our total revenue during the same period principally in respect of the revenues associated with our portfolio of domains.

Our existing agreement with Yahoo! terminates, if not renewed, in the latter part of 2007. Our existing agreements with many of our other larger distribution partners permit either company to terminate without penalty on short notice and are primarily structured on a variable-payment basis, under which we make payments based on a specified percentage of revenue or based on the number of paid click-throughs. We intend to continue devoting resources in support of our larger distribution partners, but there are no guarantees that these relationships will remain in place over the short- or long-term. In addition, we cannot be assured that any of these distribution partners will continue to generate current levels of revenue for us or that we will be able to maintain the applicable variable payment terms at their current levels. A loss of any of these distribution partners or a decrease in revenue due to lower traffic or less favorable variable payment terms from any one of these distribution relationships could have an adverse effect on our revenue, and the loss of Yahoo! or any other large distribution partner could have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

Companies distributing advertising on the Internet have experienced, and will likely continue to experience, consolidation. This consolidation has reduced the number of partners that control the online advertising outlets with the most user traffic. According to the comScore Media Metrix qSearch report for December 2006, Yahoo! Search accounted for 29% of the online searches in the United States and Google accounted for 47%. As a result, the larger distribution partners have greater control over determining the market terms of distribution, including placement of merchant advertisements and cost of placement. In addition, many participants in the performance-based advertising and search marketing industries control significant portions of the traffic that they deliver to advertisers. We do not believe, for example, that Yahoo! and Google are as reliant as we are on a third-party distribution network to deliver their services. This gives these companies a significant advantage over us in delivering their services, and with a lesser degree of risk.

We may incur liabilities for the activities of our merchant advertisers, distribution partners and other users of our services, which could adversely affect our business.

Many of our advertisement generation and distribution processes are automated. In most cases, merchant advertisers use our online tools and account management systems to create and submit merchant listings. These merchant listings are submitted in a bulk data feed to our distribution partners. Although we monitor our distribution partners on an ongoing basis primarily for traffic quality, these partners control the distribution of the merchant listings provided in the data feed.

As a result, we do not conduct a manual editorial review of a substantial number of our merchant listings, nor do we manually review the display of the vast majority of the merchant listings by our distribution partners. We may not successfully avoid liability for unlawful activities carried out by our merchant advertisers and other users of our services or unpermitted uses of our merchant listings by distribution partners and their affiliates.

Our potential liability for unlawful activities of our merchant advertisers and other users of our services or unpermitted uses of our merchant listings by distribution partners could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources, to discontinue certain service offerings or to terminate certain distribution partner relationships. For example, as a result of the actions of merchant advertisers in our network, we may be subject to private or governmental actions relating to a wide variety of issues, such as privacy, gambling, promotions, and intellectual property ownership and infringement. Under agreements with certain of our larger distribution partners, we may be required to indemnify these distribution partners against liabilities or losses resulting from the content of our merchant listings. Although our merchant advertisers indemnify us with respect to claims arising from these listings, we may not be able to recover all or any of the liabilities or losses incurred by us as a result of the activities of our merchant advertisers.

We have a large number of distribution partners who display our merchant listings on their networks. Our merchant listings are predominantly delivered to our distribution partners in an automated fashion through an XML data feed or data dump. Our distribution partners are contractually required to use the merchant listings that we provide in accordance with applicable laws and regulations and in conformity with the publication restrictions included in our agreements, which are intended to promote the quality and validity of the traffic provided to our merchant advertisers. Nonetheless, we do not operationally control or manage these distribution partners and any breach of these agreements on the part of any distribution partner or its affiliates could result in liability for our business. These agreements include indemnification obligations on the part of our distribution partners, but there is no assurance that we would be able to collect against offending distribution partners or their affiliates in the event of a claim under these indemnification provisions.

Our insurance policies may not provide coverage for liability arising out of activities of users of our services. Furthermore, we may not be able to obtain or maintain adequate insurance coverage to reduce or limit the liabilities associated with our businesses. Any costs incurred as a result of such liability or asserted liability could have a material adverse effect on our business, operating results and financial condition.

Table of Contents

If we do not maintain and grow a critical mass of merchant advertisers and distribution partners, the value of our services could be adversely affected.

Our success depends, in large part, on the maintenance and growth of a critical mass of merchant advertisers and distribution partners and a continued interest in our performance-based advertising and search marketing services. Merchant advertisers will generally seek the most competitive return on investment from advertising and marketing services. Distribution partners will also seek the most favorable payment terms available in the market. Merchant advertisers and distribution partners may change providers or the volume of business with a provider, unless the product and terms are competitive. In this environment, we must compete to acquire and maintain our network of merchant advertisers and distribution partners.

If our business is unable to maintain and grow our base of merchant advertisers, our current distribution partners may be discouraged from continuing to work with us, and this may create obstacles for us to enter into agreements with new distribution partners. Similarly, if our distribution network does not grow and does not continue to improve over time, current and prospective merchant advertisers may reduce or terminate their business with us. Any decline in the number of merchant advertisers and distribution partners could adversely affect the value of our services.

We are dependent upon the quality of traffic in our network to provide value to our merchant advertisers and the merchant advertisers of our partners, and any failure in our quality control could have a material adverse effect on the value of our services to our merchant advertisers and adversely affect our revenues.

We utilize certain monitoring processes with respect to the quality of the traffic that we deliver to our merchant advertisers. Among the factors we seek to monitor are sources and causes of low quality clicks such as non-human processes, including robots, spiders or other software, the mechanical automation of clicking, and other types of invalid clicks, click fraud, or click spam, the purpose of which is something other than to view the underlying content. Additionally, we also seek to identify other indicators which may suggest that a user may not be targeted by or desirable to our merchant advertisers. Even with such monitoring in place, there is a risk that a certain amount of low-quality traffic or traffic that is deemed to be less valuable by our merchant advertisers will be delivered to such merchant advertisers, which may be detrimental to those relationships. We have regularly refunded fees that our advertisers had paid to us which were attributed to low quality traffic. If we are unable to stop or reduce low quality traffic, these refunds may increase. Low-quality traffic may further prevent us from growing our base of merchant advertisers and cause us to lose relationships with existing merchant advertisers, or become the target of litigation, both of which would adversely affect our revenues.

We may be subject to intellectual property claims, which could adversely affect our financial condition and ability to use certain critical technologies, divert our resources and management attention from our business operations and create uncertainty about ownership of technology essential to our business.

Our success depends, in part, on our ability to protect our intellectual property and to operate without infringing on the intellectual property rights of others in the process. There can be no guarantee that any of our intellectual property will be adequately safeguarded, or that it will not be challenged by third parties. We may be subject to patent infringement claims or other intellectual property infringement claims, including claims of trademark infringement in connection with our acquisition of previously-owned Internet domain names, that would be costly to defend and could limit our ability to use certain critical technologies.

Any patent or other intellectual property litigation could negatively impact our business by diverting resources and management attention from other aspects of the business and adding uncertainty as to the ownership of technology, services and property that we view as proprietary and essential to our business. In addition, a successful claim of patent infringement against us and our failure or inability to license the infringed or similar technology on reasonable terms, or at all, could have a material adverse effect on our business.

We may need additional funding to meet our obligations and to pursue our business strategy. Additional funding may not be available to us and our financial condition could therefore be adversely affected.

We may require additional funding to meet our ongoing obligations and to pursue our business strategy, which may include the selective acquisition of businesses and technologies. In addition, we have incurred and we may incur certain obligations in the future, including:

- In February 2005, we entered into agreements with Yahoo! Search Marketing (formerly, Overture), pursuant to which we paid $4.5 million in an upfront payment (and an additional $674,000 in certain circumstances) and a contingent royalty based on 3.0% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016.

- We are obligated to pay quarterly dividends to the holders of preferred stock at an annual rate of $11.875 per preferred share. There are currently approximately 6,933 shares of preferred stock outstanding following the conversions into shares of Class B common stock or cash repurchases that have occurred to date.

- In November 2006, our board of directors authorized the repurchase of up to 3.0 million shares of our Class B common stock and the initiation of a quarterly cash dividend to the holders of common stock at an annual rate of $0.08 per common share.

- If debentures are issued upon exchange of the preferred stock, we will become obligated to make interest payments to the holders of the debentures.

There can be no assurance that if we were to need additional funds to meet these obligations that additional financing arrangements would be available in amounts or on terms acceptable to us, if at all. Furthermore, if adequate additional funds are not available, we will be required to delay, reduce the scope of, or eliminate material parts of the implementation of our business strategy, including potential additional acquisitions or internally-developed businesses.

Our acquisitions could divert management s attention, cause ownership dilution to our stockholders, cause our earnings to decrease and be difficult to integrate.

Our business strategy includes identifying, structuring, completing and integrating acquisitions. Acquisitions in the technology and Internet sectors involve a high degree of risk. We may also be unable to find a sufficient number of attractive opportunities to meet our objectives which include revenue growth, profitability and competitive market share. Our acquired companies may have histories of net losses and may expect net losses for the foreseeable future.

Acquisitions are accompanied by a number of risks that could harm our business, operating results and financial condition:

- We could experience a substantial strain on our resources, including time and money, and we may not be successful;

- Our management s attention could be diverted from our ongoing business concerns;

- While integrating new companies, we may lose key executives or other employees of these companies;

- We may issue shares of our Class B common stock as consideration for acquisitions which may result in ownership dilution to our stockholders;

We could fail to successfully integrate our financial and management controls, technology, reporting systems and procedures, or adequately expand, train and manage our workforce;

We could experience customer dissatisfaction or performance problems with an acquired company or technology;

Table of Contents

We could become subject to unknown or underestimated liabilities of an acquired entity or incur unexpected expenses or losses from such acquisitions;

We could incur possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business; and

We may be exposed to investigations and/or audits by federal, state or other taxing authorities.

Consequently, we might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated revenue and cost benefits.

The loss of our senior management, including our founding executive officers, could harm our current and future operations and prospects.

We are heavily dependent upon the continued services of Russell C. Horowitz, our chairman and chief executive officer, and John Keister, our president and chief operating officer, and the other members of our senior management team. Each member of our senior management team is an at-will employee and may voluntarily terminate his employment with us at any time with minimal notice. Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, each own shares of fully vested Class A common stock. Following any termination of employment, each of these employees would only be subject to a twelve-month non-competition and non-solicitation obligation with respect to our customers and employees under our standard confidentiality agreement.

Further, as of December 31, 2006, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister together controlled 89% of the combined voting power of our outstanding capital stock excluding shares of Class B common stock issuable upon conversion of preferred stock. Their collective voting control is not tied to their continued employment with Marchex. The loss of the services of any member of our senior management, including our founding executive officers, for any reason, or any conflict among our founding executive officers, could harm our current and future operations and prospects.

We may have difficulty retaining current personnel as well as attracting and retaining additional qualified, experienced, highly skilled personnel, which could adversely affect the implementation of our business plan.

Our performance is largely dependent upon the talents and efforts of highly skilled individuals. In order to fully implement our business plan, we will need to retain our current qualified personnel, as well as attract and retain additional qualified personnel. Thus, our success will in significant part depend upon our retention of current personnel as well as the efforts of personnel not yet identified and upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing personnel. We are also dependent on managerial and technical personnel to the extent they may have knowledge or information about our businesses and technical systems that may not be known by our other personnel. There can be no assurance that we will be able to attract and retain necessary personnel. The failure to hire and retain such personnel could adversely affect the implementation of our business plan.

If we are unable to obtain and maintain adequate insurance, our financial condition could be adversely affected in the event of uninsured or inadequately insured loss or damage. Our ability to effectively recruit and retain qualified officers and directors may also be adversely affected if we experience difficulty in maintaining adequate directors and officers liability insurance.

We may not be able to obtain and maintain insurance policies on terms affordable to us that would adequately insure our business and property against damage, loss or claims by third parties. To the extent our business or property suffers any damages, losses or claims by third parties that are not covered or adequately covered by insurance, our financial condition may be materially adversely affected.

We currently have directors and officers liability insurance. If we are unable to maintain sufficient insurance as a public company to cover liability claims made against our officers and directors, we may not be able to retain or recruit qualified officers and directors to manage our company, which could have a material adverse effect on our operations.

New rules, including those contained in and issued under the Sarbanes-Oxley Act of 2002, may make it difficult for us to retain or attract qualified officers and directors, which could adversely affect our business and our ability to maintain the listing of our Class B common stock and preferred stock on the Nasdaq Global Market.

We may be unable to attract and retain qualified officers, directors and members of board committees required to provide for our effective management as a result of the recent and currently proposed changes in the rules and regulations which govern publicly-held companies, including, but not limited to, certifications from executive officers and requirements for financial experts on boards of directors. The perceived increased personal risk associated with these recent changes may deter qualified individuals from accepting these roles. The enactment of the Sarbanes-Oxley Act of 2002 has resulted in the issuance of a series of new rules and regulations and the strengthening of existing rules and regulations by the Securities and Exchange Commission, as well as the adoption of new and more stringent rules by the Nasdaq Stock Market.

Further, certain of these recent and proposed changes heighten the requirements for board or committee membership, particularly with respect to an individual s independence from the corporation and level of experience in finance and accounting matters. We may have difficulty attracting and retaining directors with the requisite qualifications. If we are unable to attract and retain qualified officers and directors, our business and our ability to maintain the listing of our shares of Class B common stock and preferred stock on the Nasdaq Global Market could be adversely affected.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud, which could harm our brand and operating results.

Effective internal controls are necessary for us to provide reliable and accurate financial reports and effectively prevent fraud. We have devoted significant resources and time to comply with the new internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002. In addition, Section 404 under the Sarbanes-Oxley Act of 2002 requires that we assess and our auditors attest to the design and operating effectiveness of our controls over financial reporting. Our current and future compliance with the annual internal control report requirement will depend on the effectiveness of our financial reporting and data systems and controls across our operating subsidiaries. We expect these systems and controls to become increasingly complex to the extent that we integrate acquisitions and our business grows. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. We cannot be certain that these measures will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation or operation, could harm our operating results or cause us to fail to meet our financial reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock and our access to capital.

Accounting for employee stock options using the fair value method has significantly reduced and will likely continue to significantly reduce our net income.

We adopted the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R) on January 1, 2006. Thus, our consolidated financial statements for 2006 will reflect the fair value of stock options granted to employees as a compensation expense, which has had, and will in the future likely continue to have a significant adverse impact on our results of operations and net income per share.

We rely heavily on stock options to compensate existing employees and to attract new employees. If we reduce or alter our use of stock-based compensation to minimize the recognition of these expenses, our ability to recruit, motivate and retain employees may be impaired, which could put us at a competitive disadvantage in the employee marketplace. In order to prevent any net decrease in their overall compensation packages, we may choose to make corresponding increases in the cash compensation or other incentives we pay to existing and new employees. Any increases in employee wages and salaries would diminish our cash available for marketing, product development and other uses and might cause our GAAP profits to decline. Any of these effects might cause the market price of our Class B common stock and preferred stock to decline.

Impairment of goodwill and other intangible assets would result in a decrease in earnings.

Current accounting rules require that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. These rules also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased.

We have substantial goodwill and other intangible assets, and we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. Any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

We may not be able to realize the intended and anticipated benefits from our acquisitions of Internet domain names, which could affect the value of these acquisitions to our business and our ability to meet our financial obligations and targets.

We may not be able to realize the intended and anticipated benefits that we currently expect from our acquisitions of Internet domain names. These intended and anticipated benefits include increasing our cash flow from operations, broadening our distribution offerings and delivering services that strengthen our merchant relationships.

Factors that could affect our ability to achieve these benefits include:

A significant amount of revenue attributed to our domain name assets comes through our agreement with Yahoo! and its subsidiaries. Under our agreement, Yahoo! has certain limited exclusive and preferential rights with respect to the commercialization of a majority of these domain names and Web sites through paid listings. Yahoo! controls the delivery of a portion of the paid listings to a majority of these domain names and Web sites. As a result, the monetization of these Web sites is presently largely dependent on the revenue from the paid listings allocated by Yahoo! and its subsidiaries to these Web sites. This allocation may depend on Yahoo! s advertiser base, internal policies in effect from time to time, perceived quality of traffic, origin of traffic, history of performance and conversion, technical and network changes made by Yahoo!, among many factors and determinations which may or may not be controlled by us or known to us. In addition to the aforementioned factors, our existing agreement with Yahoo! terminates, if not renewed, in the latter part of 2007 and if it is terminated, we may not be able to replace it with another large-scale provider of paid listings under terms which allow us to increase or maintain the amount of revenue attributable to our domain name assets.

In the ordinary course of business we have been subject to and in the future it is likely that we will continue to be subject to intellectual property infringement claims, including claims of trademark infringement with respect to Internet domain names acquired by us. As a result of these claims, we have lost and in the future it is likely that we will continue to lose domain names from which we derive

Table of Contents

revenue. We may not be able to recoup any resulting financial losses from the prior domain name owners.

We will need to continue to acquire commercially valuable Internet domain names to grow our presence in the field of direct navigation. We will need to continuously improve our technologies to acquire valuable Internet domain names as competition in the marketplace for appropriate Internet domain names intensifies. Our domain name acquisition efforts are subject to rules and guidelines established by registries which maintain Internet domain name registrations and the registrars which process and facilitate Internet domain name registrations. The registries and registrars may change the rules and guidelines for acquiring Internet domains in ways that may prove detrimental to our domain acquisition efforts.

The business of direct navigation is dependent on current technologies and user practices. If browser or search technologies were to change significantly, the practice of direct navigation may be altered to our disadvantage.

Some of our existing distribution partners may perceive direct navigation as a competitive threat and therefore may decide to terminate their agreements with us because of our recent acquisitions of a substantial number of Internet domain names.

We intend to apply our technology and expertise to geography-specific Web sites that we believe are under-commercialized and not yet mature from a monetization perspective. However, if the current disparities in traffic and monetization of such search terms do not narrow in a favorable way, we may expend significant company resources on business efforts that do not realize the results we anticipate.

If the acquired assets are not integrated into our business as we anticipate, we may not be able to achieve these benefits or realize the value paid for our acquisitions of Internet domain names, which could materially harm our business, financial condition and results of operations.

We do not control the means by which users access our Web sites, and material changes to current navigation practices or technologies or marketing practices or significant increases in our marketing costs could result in a material adverse effect on our business.

The success of our direct navigation business depends in large part upon consumer access to our Web sites. Consumers access our Web sites primarily through the following methods: directly accessing our Web sites by typing descriptive keywords or keyword strings into the uniform resource locator (URL) address box of an Internet browser; accessing our Web sites by clicking on bookmarked Web sites; and accessing our Web sites through search engines and directories.

Each of these methods requires the use of a third party product or service, such as an Internet browser or search engine or directory. Internet browsers may provide alternatives to the URL address box to locate Web sites, and search engines may from time to time change and establish rules regarding the indexing and optimization of Web sites. We may also purchase traffic to certain Web sites from search engines as part of our marketing efforts. Historically, we have purchased traffic to certain Web sites from less than five leading search engines. Product developments and market practices for these means of access to our Web sites are not within our control. We may experience a decline in traffic to our Web sites if third party browser technologies or search engine methodologies and rules, including those affecting marketing efforts, are changed to our disadvantage. We may also be forced to significantly increase marketing expenditures in the event that market prices for online advertising and paid-listings escalate. Any of these changes could have a material adverse effect on our business.

Table of Contents

We may experience unforeseen liabilities in connection with our acquisitions of Internet domain names or arising out of third party domain names included in our distribution network, which could negatively impact our financial results.

The Name Development, Pike Street and AreaConnect asset acquisitions involve the acquisition of a large number of previously-owned Internet domain names. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names. In some cases, these acquired names may have trademark significance that is not readily apparent to us or is not identified by us in the bulk purchasing process. As a result we may face demands by third party trademark owners asserting infringement or dilution of their rights and seeking transfer of acquired Internet domain names under the Uniform Domain Name Dispute Resolution Policy administered by ICANN or actions under the U.S. Anti-Cybersquatting Consumer Protection Act. Additionally, we display paid listings on third party domain names and third party Web sites that are part of our distribution network, which also could subject us to a wide variety of civil claims including intellectual property ownership and infringement.

We intend to review each claim or demand which may arise from time to time on its merits on a case-by-case basis with the assistance of counsel and we intend to transfer any rights acquired by us to any party that has demonstrated a valid prior right or claim. We cannot, however, guarantee that we will be able to resolve these disputes without litigation. The potential violation of third party intellectual property rights and potential causes of action under consumer protection laws may subject us to unforeseen liabilities including injunctions and judgments for money damages.

Regulation could reduce the value of the Internet domain names acquired or negatively impact the Internet domain acquisition process, which could significantly impair the value attributable to our acquisitions of Internet domain names.

The Name Development business includes the registrations of thousands of Internet domain names both in the United States and internationally. Name Development acquired previously-owned Internet domain names that had expired and had been offered for sale by Internet domain name registrars following the period of permitted reclamation by their prior owners. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names, including in connection with the Pike Street and AreaConnect asset acquisitions.

The acquisition of Internet domain names generally is governed by regulatory bodies. The regulation of Internet domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional requirements for previously-owned Internet domain names or modify the requirements for holding Internet domain names. As a result, we might not acquire or maintain names that contribute to our financial results in the same manner as reflected in the historical financial results of Name Development, Pike Street and AreaConnect. Because certain Internet domain names are important assets, a failure to acquire or maintain such Internet domain names could adversely affect our financial results and our growth. Any impairment in the value of these important assets could cause our stock price to decline.

Risks Relating to Our Business and Our Industry

If we are unable to compete in the highly competitive performance-based advertising and search marketing industries, we may experience reduced demand for our products and services.

We operate in a highly competitive and changing environment. We principally compete with other companies which offer services in the following areas:

- sales to merchant advertisers of pay-per-click services;
- sales to merchant advertisers of feed management services;
- aggregation or optimization of online advertising for distribution through search engines, product shopping engines, directories, Web sites or other outlets;

Table of Contents

- delivery of online advertising to end users or customers of merchants through destination Web sites or other distribution outlets;
- local search sales training;
- services and outsourcing of technologies that allow merchants to manage their advertising campaigns across multiple networks and track the success of these campaigns; and
- third party domain monetization.

Although we currently pursue a strategy that allows us to potentially partner with all relevant companies in the industry, there are certain companies in the industry that may not wish to partner with us. Despite the fact that we currently work with several of our potential competitors, there are no guarantees that these companies will continue to work with us in the future.

We currently or potentially compete with a variety of companies, including Miva, Google, Microsoft and Yahoo! Many of these actual or perceived competitors also currently or may in the future have business relationships with us, particularly in distribution. However, such companies may terminate their relationships with us. Furthermore, our competitors may be able to secure agreements with us on more favorable terms, which could reduce the usage of our services, increase the amount payable to our distribution partners, reduce total revenue and thereby have a material adverse effect on our business, operating results and financial condition.

We expect competition to intensify in the future because current and new competitors can enter our market with little difficulty. The barriers to entering our market are relatively low. In fact, many current Internet and media companies presently have the technical capabilities and advertiser bases to enter the search marketing services industry. Further, if the consolidation trend continues among the larger media and search engine companies with greater brand recognition, the share of the market remaining for smaller search marketing services providers could decrease, even though the number of smaller providers could continue to increase. These factors could adversely affect our competitive position in the search marketing services industry.

Some of our competitors, as well as potential entrants into our market, may be better positioned to succeed in this market. They may have:

- longer operating histories;
- more management experience;
- an employee base with more extensive experience;
- better geographic coverage;
- larger customer bases;
- greater brand recognition; and
- significantly greater financial, marketing and other resources.

Currently, and in the future, as the use of the Internet and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies and/or invest in or form joint ventures in categories or countries of interest to us, all of which could adversely impact our business. Any of these trends could increase competition and reduce the demand for any of our services.

We face competition from traditional media companies, and we may not be included in the advertising budgets of large advertisers, which could harm our operating results.

In addition to Internet companies, we face competition from companies that offer traditional media advertising opportunities. Most large advertisers have set advertising budgets, a very small portion of which is allocated to

Table of Contents

Internet advertising. We expect that large advertisers will continue to focus most of their advertising efforts on traditional media. If we fail to convince these companies to spend a portion of their advertising budgets with us, or if our existing advertisers reduce the amount they spend on our programs, our operating results would be harmed.

If we are not able to respond to the rapid technological change characteristic of our industry, our products and services may cease to be competitive.

The market for our products and services is characterized by rapid change in business models and technological infrastructure, and we will need to constantly adapt to changing markets and technologies to provide new and competitive products and services. If we are unable to ensure that our users, advertisers, and distribution partners have a high-quality experience with our products and services, then they may become dissatisfied and move to competitors products and services. Accordingly, our future success will depend, in part, upon our ability to develop and offer competitive products and services for both our target market and for applications in new markets. We may not, however, be able to successfully do so, and our competitors may develop innovations that render our products and services obsolete or uncompetitive.

Our technical systems are vulnerable to interruption and damage that may be costly and time-consuming to resolve and may harm our business and reputation.

A disaster could interrupt our services for an indeterminate length of time and severely damage our business, prospects, financial condition and results of operations. Our systems and operations are vulnerable to damage or interruption from:

- fire;
- floods;
- network failure;
- hardware failure;
- software failure;
- power loss;
- telecommunications failures;
- break-ins;
- terrorism, war or sabotage;
- computer viruses;

- denial of service attacks;
- penetration of our network by unauthorized computer users and hackers and other similar events;
- natural disaster; and
- other unanticipated problems.

We may not have developed or implemented adequate protections or safeguards to overcome any of these events. We also may not have anticipated or addressed many of the potential events that could threaten or undermine our technology network. Any of these occurrences could cause material interruptions or delays in our business, result in the loss of data or render us unable to provide services to our customers. In addition, if a person is able to circumvent our security measures, he or she could destroy or misappropriate valuable information or disrupt our operations. We have deployed firewall hardware intended to thwart hacker attacks. Although we maintain property insurance and business interruption insurance, our insurance may not be adequate to compensate us for all losses that may occur as a result of a catastrophic system failure or other loss, and our insurers may not be able or may decline to do so for a variety of reasons.

Table of Contents

If we fail to address these issues in a timely manner, we may lose the confidence of our merchant advertisers and distribution partners, our revenue may decline and our business could suffer. In addition, as we expand our service offerings and enter into new business areas, we may be required to significantly modify and expand our software and technology platform. If we fail to accomplish these tasks in a timely manner, our business and reputation will likely suffer.

We rely on third party technology, server and hardware providers, and a failure of service by these providers could adversely affect our business and reputation.

We rely upon third party colocation providers to host our main servers. If these providers are unable to handle current or higher volumes of use, experience any interruption in operations or cease operations for any reason or if we are unable to agree on satisfactory terms for continued hosting relationships, we would be forced to enter into a relationship with other service providers or assume hosting responsibilities ourselves. If we are forced to switch hosting facilities, we may not be successful in finding an alternative service provider on acceptable terms or in hosting the computer servers ourselves. We may also be limited in our remedies against these providers in the event of a failure of service. In the past, we have experienced short-term outages in the service maintained by one of our current colocation providers. We also rely on third party providers for components of our technology platform, such as hardware and software providers, credit card processors and domain name registrars. A failure or limitation of service or available capacity by any of these third party providers could adversely affect our business and reputation.

We may not be able to protect our intellectual property rights, which could result in our competitors marketing competing products and services utilizing our intellectual property and could adversely affect our competitive position.

Our success and ability to compete effectively are substantially dependent upon our internally developed and acquired technology and data resources, which we protect through a combination of copyright, trade secret, and patent and trademark law. To date, we have filed two provisional patent applications with the United States Patent and Trademark Office, and three non-provisional patent applications two of which are based on the two filed provisional applications in the United States. In the future, additional patents may be filed with respect to internally developed or acquired technologies. Our industry is highly competitive and many individuals and companies have sought to patent processes in the industry. In addition, the patent process takes several years and involves considerable expense. Further, patent applications and patent positions in our industry are highly uncertain and involve complex legal and factual questions due in part to the number of competing technologies. As a result, we may not be able to successfully prosecute these patents, in whole or in part, or any additional patent filings that we may make in the future. We also depend on our trade name and domain names. We may not be able to adequately protect our technology and data resources. In addition, intellectual property laws vary from country to country, and it may be more difficult to protect our intellectual property in some foreign jurisdictions in which we may plan to enter. If we fail to obtain and maintain patent or other intellectual property protection for our technology, our competitors could market competing products and services utilizing our technology.

Despite our efforts to protect our proprietary rights, unauthorized parties domestically and internationally may attempt to copy or otherwise obtain and use our services, technology and other intellectual property. We cannot be certain that the steps we have taken will prevent any misappropriation or confusion among consumers and merchant advertisers. If we are unable to protect our intellectual property rights from unauthorized use, our competitive position could be adversely affected.

We may be involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming.

We may initiate patent litigation against third parties to protect or enforce our patent rights, and we may be similarly sued by others. We may also become subject to interference proceedings conducted in the patent and

Table of Contents

trademark offices of various countries to determine the priority of inventions. The defense and prosecution, if necessary, of intellectual property suits, interference proceedings and related legal and administrative proceedings is costly and may divert our technical and management personnel from their normal responsibilities. We may not prevail in any of these suits. An adverse determination of any litigation or defense proceedings could put our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not being issued.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could have an adverse effect on the trading price of our Class B common stock and the trading price of our preferred stock.

Our quarterly results of operations might fluctuate due to seasonality, which could adversely affect our growth rate and in turn the market price of our securities.

Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in the level of Internet usage. As is typical in our industry, the second and third quarters of the calendar year generally experience relatively lower usage than the first and fourth quarters. It is generally understood that during the spring and summer months of the year, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and in turn the market price of our securities.

We are susceptible to general economic conditions, and a downturn in advertising and marketing spending by merchants could adversely affect our operating results.

Our operating results will be subject to fluctuations based on general economic conditions, in particular those conditions that impact merchant-consumer transactions. If there were to be a general economic downturn that affected consumer activity in particular, however slight, then we would expect that business entities, including our merchant advertisers and potential merchant advertisers, could substantially and immediately reduce their advertising and marketing budgets. We believe that during periods of lower consumer activity, merchant spending on advertising and marketing is more likely to be reduced, and more quickly, than many other types of business expenses. These factors could cause a material adverse effect on our operating results.

We depend on the growth of the Internet and Internet infrastructure for our future growth and any decrease in growth or anticipated growth in Internet usage could adversely affect our business prospects.

Our future revenue and profits, if any, depend upon the continued widespread use of the Internet as an effective commercial and business medium. Factors which could reduce the widespread use of the Internet include:

- possible disruptions or other damage to the Internet or telecommunications infrastructure;
- failure of the individual networking infrastructures of our merchant advertisers and distribution partners to alleviate potential overloading and delayed response times;
- a decision by merchant advertisers and consumers to spend more of their marketing dollars on offline programs;
- increased governmental regulation and taxation; and
- actual or perceived lack of security or privacy protection.

Table of Contents

In particular, concerns over the security of transactions conducted on the Internet and the privacy of users, including the risk of identity theft, may inhibit the growth of Internet usage, especially online commercial transactions. In order for the online commerce market to develop successfully, we and other market participants must be able to transmit confidential information, including credit card information, securely over public networks. Any decrease in anticipated Internet growth and usage could have a material adverse effect on our business prospects.

We are exposed to risks associated with credit card fraud and credit payment, and we may continue to suffer losses as a result of fraudulent data or payment failure by merchant advertisers.

We have suffered losses and may continue to suffer losses as a result of payments made with fraudulent credit card data. Our failure to control fraudulent credit card transactions adequately could reduce our net revenue and gross margin and negatively impact our standing with applicable credit card authorization agencies. In addition, under limited circumstances, we extend credit to merchant advertisers who may default on their accounts payable to us or fraudulently charge-back amounts on their credit cards for services that have already been delivered by us.

Government regulation of the Internet may adversely affect our business and operating results.

Online search, e-commerce and related businesses face uncertainty related to future government regulation of the Internet through the application of new or existing federal, state and international laws. Due to the rapid growth and widespread use of the Internet, legislatures at the federal and state level have enacted and may continue to enact various laws and regulations relating to the Internet. Individual states may also enact consumer protection laws that are more restrictive than the ones that already exist.

Furthermore, the application of existing laws and regulations to Internet companies remains somewhat unclear. For example, as a result of the actions of merchant advertisers in our network, we may be subject to existing laws and regulations relating to a wide variety of issues such as consumer privacy, gambling, sweepstakes, advertising, promotions, defamation, pricing, taxation, financial market regulation, quality of products and services, computer trespass, spyware, adware, child protection and intellectual property ownership and infringement. In addition, it is not clear whether existing laws that require licenses or permits for certain of our merchant advertisers lines of business apply to us, including those related to insurance and securities brokerage, law offices and pharmacies. Existing federal and state laws that may impact the growth and profitability of our business include, among others:

- the Digital Millennium Copyright Act (DMCA) provides protection from copyright liability for online service providers that list or link to third party Web sites. We currently qualify for the safe harbor under the DMCA, however, if it were determined that we did not meet the safe harbor requirements, we could be exposed to copyright infringement litigation, which could be costly and time-consuming.

- the Children s Online Privacy Protection Act (COPPA) restricts the distribution of certain materials deemed harmful to children and impose limitations on the Web sites ability to collect personal information from minors. COPPA allows the Federal Trade Commission (FTC) to impose fines and penalties upon Web site operators whose sites do not fully comply with the law s requirements. Another child protection law, the Child Online Protection Act (COPA), was intended to restrict the distribution of certain materials deemed harmful to children. This law was struck down as unconstitutional, but a similar federal or state law might be reintroduced in the future.

- the Protection of Children from Sexual Predators Act requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.

- the Controlling the Assault of Non-Solicited Pornography and Marketing (CAN SPAM) Act of 2003 establishes requirements for those who send commercial e-mail, spells out penalties for entities that transmit noncompliant commercial e-mail and/or whose products are advertised in noncompliant

Table of Contents

commercial e-mail and gives consumers the right to opt-out of receiving commercial e-mails. The FTC is authorized to enforce the CAN-SPAM Act. This law also gives the Department of Justice the authority to enforce its criminal sanctions. Other federal and state agencies can enforce the law against organizations under their jurisdiction, and companies that provide Internet access may sue violators as well.

the Electronic Communications Privacy Act prevents private entities from disclosing Internet subscriber records and the contents of electronic communications, subject to certain exceptions.

the Computer Fraud and Abuse Act and other federal and state laws protect computer users from unauthorized computer access/hacking, and other actions by third parties which may be viewed as a violation of privacy. Michigan and Utah child protection laws, designed to protect children under the age of 18 from receiving adult content via e-mail and other electronic forms of communication (e.g., cell phones and IM). Both Michigan and Utah have developed lists of minors e-mail addresses based on parents and guardians submissions. Once an address has been on a list for 30 days, Web publishers are prohibited from sending the address anything containing, or even linking to, advertising for a product or service that a minor is legally prohibited from purchasing or using, even if the owner of that address previously requested to receive the information. In addition, senders need to match their own mailing lists against the state registries on at least a monthly basis, for which they must pay both Michigan and Utah a per-address fee.

Courts may apply each of these laws in unintended and unexpected ways. As a company that provides services over the Internet, we may be subject to an action brought under any of these or future laws governing online services. Among the types of legislation currently being considered at the federal and state levels are consumer laws regulating for the use of certain types of software applications or downloads and the use of cookies. These proposed laws are intended to target specific types of software applications often referred to as spyware, invasiveware or adware, although they may also cover certain applications currently used in the online advertising industry to serve and distribute advertisements. Thus, if passed, these laws would impose new obligations for companies that use such software applications or technologies.

Many Internet services are automated, and companies such as ours may be unknowing conduits for illegal or prohibited materials. It is possible that some courts may impose a strict liability standard or require such companies to monitor their customers conduct. Although we would not be responsible or involved in any way in such illegal conduct, it is possible that we would somehow be held responsible for the actions of our merchant advertisers or distribution partners.

We may also be subject to costs and liabilities with respect to privacy issues. Several Internet companies have incurred penalties for failing to abide by the representations made in their privacy policies. In addition, several states have adopted legislation that requires businesses to implement and maintain reasonable security procedures and practices to protect sensitive personal information and to provide notice to consumers in the event of a security breach. Further, it is anticipated that additional federal and state privacy-related legislation will be enacted. Such legislation could negatively affect our business.

In addition, foreign governments may pass laws which could negatively impact our business and/or may prosecute us for violating existing laws. Such laws might include EU member country conforming legislation under applicable EU Privacy and Data Protection Directives. Any costs incurred in addressing foreign laws could negatively affect the viability of our business.

Future regulation of search engines may adversely affect the commercial utility of our search marketing services.

The Federal Trade Commission, or FTC, has recently reviewed the way in which search engines disclose paid placements or paid inclusion practices to Internet users. In 2002, the FTC issued guidance recommending that all search engine companies ensure that all paid search results are clearly distinguished from non-paid results, that the use of paid inclusion is clearly and conspicuously explained and disclosed and that other disclosures are made to avoid misleading users about the possible effects of paid placement or paid inclusion listings on search results. Such disclosures if ultimately mandated by the FTC or voluntarily made by us may reduce the desirability of our paid placement and paid inclusion services. We believe that some users will conclude that paid search results are not subject to the same relevancy requirements as non-paid search results, and will view paid search results less favorably. If such FTC disclosure reduces the desirability of our paid placement and paid inclusion services, and click-throughs of our paid search results decrease, our business could be adversely affected.

State and local governments may in the future be permitted to levy additional taxes on Internet access and electronic commerce transactions, which could result in a decrease in the level of usage of our services. In addition, we may be required to pay additional income, sales, or other taxes.

On November 19, 2004, the federal government passed legislation placing a three-year ban on state and local governments imposition of new taxes on Internet access or electronic commerce transactions. Unless the ban is extended, state and local governments may begin to levy additional taxes on Internet access and electronic commerce transactions upon the legislation s expiration in November 2007. An increase in taxes may make electronic commerce transactions less attractive for merchants and businesses, which could result in a decrease in the level of usage of our services. Additionally, from time to time, various state, federal and other jurisdictional tax authorities undertake reviews of the Company and the Company s filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. We cannot predict the outcome of any of these reviews.

Risks Relating to Ownership of our Common Stock and Preferred Stock

Our Class B common stock and preferred stock prices have been and are likely to continue to be highly volatile.

The trading prices of our Class B common stock and preferred stock have been and are likely to continue to be highly volatile and subject to wide fluctuations. Since our initial public offering, the closing sale price of our Class B common stock on the Nasdaq Global Market (formerly, the Nasdaq National Market) ranged from $8.56 to $26.14 per share through December 31, 2006. Since our February 2005 follow-on offering, the closing sale price of our preferred stock on the Nasdaq Global Market (formerly, the Nasdaq National Market) ranged from $150.71 to $267.00 per share through December 31, 2006. Our stock prices may fluctuate in response to a number of events and factors, which may be the result of our business strategy or events beyond our control, including:

- developments concerning proprietary rights, including patents, by us or a competitor;
- announcements by us or our competitors of significant contracts, acquisitions, financings, commercial relationships, joint ventures or capital commitments;
- registration of additional shares of Class B common stock in connection with acquisitions;
- actual or anticipated fluctuations in our operating results;
- developments concerning our various strategic collaborations;
- lawsuits initiated against us or lawsuits initiated by us;
- announcements of acquisitions or technical innovations;

potential loss or reduced contributions from distribution partners or merchant advertisers;

changes in earnings estimates or recommendations by analysts;

changes in the market valuations of similar companies;

changes in our industry and the overall economic environment;

volume of shares of Class B common stock available for public sale, including on conversion of Class A common stock and preferred stock or upon exercise of stock options;

Class B common stock repurchases under our previously announced share repurchase program;

sales of stock by us or by our stockholders, including sales by certain of our executive officers and directors pursuant to written pre-determined selling plans under Rule 10b5-1 of the Securities Exchange Act of 1934; and

short sales, hedging and other derivative transactions on shares of our Class B common stock and preferred stock.

In addition, the stock market in general, and the Nasdaq Global Market and the market for online commerce companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of the listed companies. These broad market and industry factors may seriously harm the market price of our Class B common stock and preferred stock, regardless of our operating performance. In the past, following periods of volatility in the market, securities class action litigation has often been instituted against these companies. Litigation against us, whether or not judgment is entered against us, could result in substantial costs and potentially economic loss, and a diversion of our management s attention and resources, any of which could seriously harm our financial condition. Additionally, there can be no assurance that an active trading market of our Class B common stock and preferred stock will be sustained.

Because our shares of the preferred stock are convertible into shares of Class B common stock, volatility or depressed prices for our Class B common stock could have a similar effect on the value of the preferred stock. Holders who receive Class B common stock upon conversion also will be subject to the risk of volatility and depressed prices of our Class B common stock.

Our founding executive officers control the outcome of stockholder voting, and there may be an adverse effect on the price of our Class B common stock due to the disparate voting rights of our Class A common stock and our Class B common stock.

As of December 31, 2006, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, beneficially owned 96% of the outstanding shares of our Class A common stock, which shares represented 88% of the combined voting power of all outstanding shares of our capital stock. These founding executive officers together control 89% of the combined voting power of all outstanding shares of our capital stock excluding shares of Class B common stock issuable upon conversion of the preferred stock. The holders of our Class A common stock and Class B common stock have identical rights except that the holders of our Class B common stock are entitled to one vote per share, while holders of our Class A common stock are entitled to twenty-five votes per share on all matters to be voted on by stockholders. This concentration of control could be disadvantageous to our other stockholders with interests different from those of these founding executive officers. This difference in the voting rights of our Class A common stock and Class B common stock could adversely affect the price of our Class B common stock to the extent that investors or any potential future purchaser of our shares of Class B common stock give greater value to the superior voting rights of our Class A common stock.

Further, as long as these founding executive officers have a controlling interest, they will continue to be able to elect all or a majority of our board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, these founding executive officers will be in a position to continue to control all fundamental matters affecting our company, including any merger involving, sale of substantially all of the assets of, or change in control of, our company. The ability of these founding executive officers to control our company may result in our Class B common stock and preferred stock trading at a price lower than the price at which such stock would trade if these founding executive officers did not have a controlling interest in us. This control may deter or prevent a third party from acquiring us which could adversely affect the market price of our Class B common stock and preferred stock.

Table of Contents

Anti-takeover provisions may limit the ability of another party to acquire us, which could cause our stock price to decline.

Our certificate of incorporation, as amended, our by-laws and Delaware law contain provisions that could discourage, delay or prevent a third party from acquiring us, even if doing so may be beneficial to our stockholders. In addition, these provisions could limit the price investors would be willing to pay in the future for shares of our Class B common stock and preferred stock. The following are examples of such provisions in our certificate of incorporation, as amended, or our by-laws:

- the authorized number of our directors can be changed only by a resolution of our board of directors;
- advance notice is required for proposals that can be acted upon at stockholder meetings;
- there are limitations on who may call stockholder meetings; and
- our board of directors is authorized, without prior stockholder approval, to create and issue blank check preferred stock.

We are also subject to Section 203 of the Delaware General Corporation Law, which provides, subject to enumerated exceptions, that if a person acquires 15% or more of our voting stock, the person is an interested stockholder and may not engage in business combinations with us for a period of three years from the time the person acquired 15% or more of our voting stock. The application of Section 203 of the Delaware General Corporation Law could have the effect of delaying or preventing a change of control of our company.

Conversion of our convertible preferred stock has and will dilute the interests of our existing Class B common stockholders.

The conversion of some or all of the preferred stock has and will dilute the interests of our existing Class B common stockholders. Sales in the public market of shares of Class B common stock issued upon conversion may apply downward pressure on the prevailing market price. In addition, the mere issuance of the preferred stock represents a future issuance, and perhaps a future sale, of our Class B common stock to be acquired upon conversion, which could depress trading prices for our Class B common stock.

We may not be able to continue to pay dividends on our preferred stock or common stock in the future which could impair the value of such stock.

Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year or the fiscal year before which the dividend is declared. We have paid a quarterly dividend on our preferred stock since May of 2005. In addition, we recently instituted and paid a quarterly dividend on our common stock. However, there is no assurance that we will be able to pay dividends in the future. Our ability to pay dividends in the future will depend on our financial results, liquidity and financial condition.

The market price of the preferred stock may decline.

An active trading market for the preferred stock has not fully developed and as a result, the market price and liquidity of the preferred stock will be adversely affected. Even if an active trading market for the preferred stock were to develop, the preferred stock could trade for less than the public offering price, depending on many factors, including prevailing interest rates, our operating results and the markets for similar securities, and such active trading market could cease to continue at any time. In addition, if the preferred stock is exchanged for debentures, we are not obligated to list the debentures and cannot assure you that a market for the debentures will develop.

Table of Contents

There may be tax consequences to the holders if we exchange preferred stock for debentures.

An exchange of the preferred stock for debentures will be a taxable event for federal income tax purposes which may result in tax liability to the holders without any corresponding receipt of cash by the holder. Such an exchange may be taxable as a dividend distribution to the extent of our current and accumulated earnings and profits, and may be subject to withholding tax if the exchanging stockholder is a Non-U.S. Holder.

Our current and future payment obligations or indebtedness will have priority over a preferred stock liquidation preference and accrued dividend payment obligation in the event of our liquidation, dissolution or winding-up.

The terms of the preferred stock do not contain any financial or operating covenants that would prohibit or limit us or our subsidiaries from incurring indebtedness or other liabilities, pledging assets to secure such indebtedness and liabilities, paying dividends, or issuing securities or repurchasing securities issued by us or any of our subsidiaries. The incurrence of indebtedness by us or our subsidiaries and, in particular, the granting of a security interest to secure the indebtedness could adversely affect our ability to pay accrued dividends under the terms of the preferred stock.

If we incur indebtedness, the holders of that debt will have prior rights with respect to any proceeds distributed in connection with any insolvency, liquidation, reorganization, dissolution or other winding-up of us. This may have the effect of reducing the amount of proceeds in connection with any insolvency, liquidation, reorganization or other winding-up of us paid to holders of the preferred stock.

The rights of holders of the Class B common stock will be junior to the rights of holders of the preferred stock in the event of our liquidation, dissolution or winding-up.

The terms of the preferred stock provide that holders will receive a preference over the other equity securities of the company upon its liquidation, dissolution or winding-up. This liquidation preference is equal to $250 per share of preferred stock plus all accrued and unpaid dividends through the distribution date. These rights of payment are senior to the liquidation rights of the holders of the Class B common stock. This may have the effect of reducing the amount of proceeds in connection with any insolvency, liquidation, reorganization or other winding-up of us paid to holders of the Class B common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

Our headquarters are located in Seattle, Washington and consist of approximately 44,000 square feet of leased office space expiring in December 2009. We also lease approximately 11,000 square feet of office space in Orem, Utah which expires in August 2008 and 6,000 square feet of office space in Eugene, Oregon which expires in October 2007. We also lease additional office space in Las Vegas, Nevada and New York, New York. These leases represent an aggregate of approximately 8,000 square feet of office space with lease terms expiring between February 2007 and November 2010. Our information technology systems are hosted and maintained in third party facilities under collocation services agreements. See Item 1 of this Annual Report on Form 10-K under the caption Information Technology and Systems.

We believe that our existing facilities, together with additional space we believe we can lease at reasonable market rates, are adequate for our near term business needs.

Table of Contents

ITEM 3. LEGAL PROCEEDINGS.

We are not a party to any material legal proceedings. From time to time, however, we may be subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of intellectual property rights, and a variety of claims arising in connection with our services.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted during the fourth quarter of 2006 to a vote of security holders, through solicitation of proxies or otherwise.

Table of Contents

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Market Information

Our Class B common stock has been traded on the Nasdaq Global Market (formerly, the Nasdaq National Market) under the symbol MCHX since March 31, 2004 when we completed our initial public offering at a price of $6.50 per share. Prior to that time, there was no public market for our Class B common stock. The following table sets forth, for the periods indicated, the high and low closing sales prices for Marchex s Class B common stock as reported on the Nasdaq Global Market:

	High	Low
Year ended December 31, 2005		
First Quarter	$ 24.71	$ 16.63
Second Quarter	$ 18.44	$ 13.82
Third Quarter	$ 18.04	$ 13.67
Fourth Quarter	$ 25.66	$ 14.23
Year ended December 31, 2006		
First Quarter	$ 26.14	$ 20.43
Second Quarter	$ 22.82	$ 15.08
Third Quarter	$ 16.79	$ 12.69
Fourth Quarter	$ 17.13	$ 12.82

Holders

As of March 12, 2007, there were 41,907,784 shares of common stock outstanding that were held by 123 stockholders of record. Of these shares:

11,659,216 shares were issued as Class A common stock, and as of this date were held by 5 stockholders of record; and

30,248,568 shares were issued as Class B common stock, and as of this date were held by 118 stockholders of record.

Dividends

In February 2005, the Company issued 230,000 shares of 4.75% convertible exchangeable preferred stock with a liquidation preference of $250 per share.

We currently pay cash dividends on the preferred stock at the annual rate of 4.75% per share. Dividends on the preferred stock are cumulative, meaning that if they are not paid they continue to accrue and must be paid prior to the payment of any dividends on our common stock.

In November 2006, we initiated a quarterly cash dividend at $0.02 per share of Class A common stock and Class B common stock which was paid on February 15, 2007 to stockholders of record as of the close of business on February 2, 2007. The aggregate quarterly dividend paid was approximately $832,000. Although we expect that the annual cash dividend, subject to capital availability, will be $0.08 per common share or approximately $3.3 million for the foreseeable future, there can be no assurance that we will continue to pay dividends at such rate or at all.

Table of Contents

Issuer Purchases of Equity Securities

During the fourth quarter of 2006, share repurchase activity was as follows:

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares (or approximate dollar value) that may yet be purchased under the plans or programs [2]
Class B Common Shares:				
October 1, 2006 - October 31, 2006				
November 1, 2006 - November 30, 2006				
December 1, 2006 - December 31, 2006	11,092[1]	$ 0.01		
Total Class B Common Shares	11,092	$ 0.01		3,000,000
Total Preferred Shares	132,379[3]	$ 195 (plus commissions)		

(1) All shares were shares of restricted equity subject to vesting which were issued to employees in connection with certain of our acquisitions. We repurchased the shares above which were not already vested from certain of our employees upon their termination of employment.

(2) On November 15, 2006, we announced that our Board of Directors authorized a share repurchase program to repurchase up to 3 million shares of our Class B common stock through open market and privately negotiated transactions, at times and in such amounts as we deem appropriate. No shares will be knowingly purchased from company insiders or their affiliates. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice. No repurchases have been made under this program to date.

(3) The preferred shares were repurchased in December 2006 pursuant to privately negotiated transactions.

Table of Contents

Stock Performance Graph

This performance graph shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act) or otherwise subject to the liabilities under that Section and shall not be deemed to be incorporated by reference into any filing of Marchex under the Securities Act of 1933, as amended or the Exchange Act.

The following graph shows a comparison from March 31, 2004 (the date our Class B common stock commenced trading on the Nasdaq Global Market (formerly, the Nasdaq National Market)) through December 31, 2006 of cumulative total return for our Class B common stock, the NASDAQ Composite Index (the NASDAQ Composite Index) and the RDG Internet Composite Index (the RDG Index). Measurement points are March 31, 2004 and the last trading day of each of the Company s fiscal years ended December 31, 2004, December 31, 2005 and December 31, 2006. The graph assumes that $100 was invested on March 31, 2004 in the Class B common stock of the Company, the NASDAQ Composite Index and the RDG Internet Composite Index and assumes reinvestment of any dividends. Such returns are based on historical results and are not intended to suggest future performance.

COMPARISON OF 33 MONTH CUMULATIVE TOTAL RETURN

Among Marchex, Inc., the NASDAQ Composite Index and the RDG Internet Composite Index

	3/31/04	12/31/04	12/31/05	12/31/06
Marchex, Inc.	$ 100	$ 236.49	$ 253.27	$ 150.68
NASDAQ Composite Index	$ 100	$ 109.31	$ 112.39	$ 124.28
RDG Internet Composite Index	$ 100	$ 113.74	$ 111.68	$ 123.83

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA.

The following selected consolidated financial data should be read in conjunction with Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes appearing elsewhere in this Form 10-K.

The consolidated statement of operations data for the year ended December 31, 2002 and the period from January 1 to February 28, 2003 and the consolidated balance sheet data at December 31, 2002 and February 28, 2003, referred to as the predecessor periods, represent the historical results of eFamily.com, Inc and its wholly owned subsidiary, Enhance Interactive (formerly known as ah-ha.com) prior to the acquisition. On February 28, 2003, we acquired 100% of the outstanding stock of eFamily.com, Inc. and its wholly-owned subsidiary, Enhance Interactive. The acquisition was accounted for as a business combination. The consolidated statement of operations for the period from January 17 to December 31, 2003 and the consolidated balance sheet data at December 31, 2003, are our results from inception through the end of the year which includes the results of Enhance Interactive since the acquisition date. The consolidated financial data for these periods are derived from our audited consolidated financial statements that are not included in this Form 10-K.

The consolidated statement of operations data for the years ended December 31, 2004, 2005, and 2006, and the consolidated balance sheet data at December 31, 2005 and 2006, are derived from our audited consolidated financial statements appearing elsewhere in this Form 10-K.

The historical results are not necessarily indicative of the results to be expected in any future period.

Consolidated Statements of Operations Data:

	Predecessor Periods		Marchex (Successor Periods)			
			January 17 (inception) to	Years ended December 31,		
	Year ended December 31, 2002	January 1 to February 28, 2003	December 31, 2003	2004	2005	2006
Revenue	$ 10,070,507	$ 3,071,055	$ 19,892,158	$ 43,804,272	$ 94,995,847	$ 127,759,475
Income (loss) from operations	$ (238,150)	$ 556,601	$ (3,327,723)	$ (1,017,746)	$ 4,849,510	$ 551,860
Net income (loss)	$ (89,783)	$ 332,519	$ (2,169,352)	$ (733,093)	$ 3,907,806	$ (443,637)
Net income (loss) applicable to common stockholders	$ (89,783)	$ 332,519	$ (3,488,237)	$ (1,153,523)	$ 1,502,026	$ 2,753,704
Basic net income (loss) per share applicable to common stockholders			$ (0.26)	$ (0.05)	$ 0.04	$ 0.07
Diluted net income (loss) per share applicable to common stockholders			$ (0.26)	$ (0.05)	$ 0.04	$ (0.04)
Shares used to calculate basic net income (loss) per share applicable to common stockholders			13,259,747	22,087,503	34,564,790	38,261,884
Shares used to calculate diluted net income (loss) per share applicable to common stockholders			13,259,747	22,087,503	36,907,633	39,500,123

Consolidated Balance Sheet Data:

	Predecessor Period		Marchex (Successor Period)			
	December 31,	February 28,	As of December 31,			
	2002	2003	2003	2004	2005	2006
Cash and cash equivalents	$ 1,494,300	$ 1,820,763	$ 6,019,119	$ 24,933,066	$ 63,090,941	$ 46,105,827
Working capital	$ (135,244)	$ 506,008	$ (158,523)	$ 16,062,631	$ 70,269,596	$ 56,787,483
Total assets	$ 2,679,293	$ 3,109,241	$ 33,702,612	$ 71,593,736	$ 334,409,149	$ 333,387,836
Total liabilities	$ 2,309,028	$ 2,099,150	$ 10,427,878	$ 15,921,704	$ 13,795,557	$ 16,174,934
Series A redeemable convertible preferred stock	$	$	$ 21,440,402	$	$	$
Total stockholders equity	$ 370,265	$ 1,010,091	$ 1,834,332	$ 55,672,032	$ 320,613,592	$ 317,212,902

Table of Contents

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion should be read in conjunction with the audited consolidated financial statements and the notes to those statements which appear elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements. Please see page 1 on this Annual Report on Form 10-K Forward-Looking Statements and Item 1A of this Annual Report on Form 10-K under the caption Risk Factors for a discussion of the risks, uncertainties and assumptions associated with these statements.

Overview

We deliver vertical and local online traffic to merchant advertisers, and help publishers monetize traffic on their Web site(s). Our platform of performance-based advertising and search marketing services enables merchants to market their products or services across relevant online distribution points, including search engines, product shopping engines, vertical Web sites, and local Web sites; and enable publishers with merchant advertisers who are looking to market their products or services on the publisher search network, shopping network, or Web site, or a specific page of the publisher Web site.

We currently provide our merchant advertisers with the following technology-based services:

- ***Local and Vertical Web Sites.*** We have more than 200,000 vertical and local Web sites. Our Web sites are designed to help online users find information for specific products or services, and also find relevant advertisers who sell such products or services. We refer to this service as direct navigation.

- ***Contextual Targeting.*** We sell advertising placement on specialized vertical and branded Web sites, and on specific sections of a Web site advertising listings on a bid-for-click basis. We also refer to this service as site-specific contextual advertising. We believe this site-specific approach to contextual advertising provides publishers with an opportunity to monetize the value of their own brand and traffic, and gives advertisers greater transparency and relevancy.

- ***Pay-Per-Click Targeting.*** We deliver pay-per-click advertising listings that are reflective of our merchant advertisers products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories, certain third-party Web sites and our portfolio of owned Web sites. We also generate revenue from cost-per-action services, which occur when the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to a merchant advertiser Web site and completes the specified action.

- ***Natural Search Engine Optimization.*** We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

- ***Outsourced Search Marketing Platforms.*** We support online marketing efforts of local businesses and SMEs (small and medium-sized enterprises) by providing super-aggregator partners, such as yellow page publishers and newspaper companies, with an outsourced platform of our performance-based advertising and search marketing technology services. Our outsourced platform allows super-aggregator partners to directly sell search marketing packages to their customers, such as yellow page or classified advertisers. Our outsourced platform for publishers, which is separate and distinct from the local platform, allows publishers to monetize their Web site(s) with their advertiser relationships. Our outsourced platforms are provided to super-aggregator partners and publishers allowing the partners and publishers to sell under their brand.

- ***Feed Management.*** We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. Our trusted feed relationships with our

Table of Contents

distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web s largest search engines, product shopping engines and directories.

Bid Management. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date. We have completed the following acquisitions since our inception:

On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive. eFamily was incorporated in Utah on November 29, 1999 under the name FocusFilter.com, Inc.

On October 24, 2003, we acquired TrafficLeader, which was incorporated in Oregon on January 24, 2000 under the name Sitewise Marketing, Inc.

On July 27, 2004, we acquired goClick, which was incorporated in Connecticut on October 25, 2000.

On February 14, 2005, we acquired certain assets of Name Development, which was incorporated in the British Virgin Islands in July 2000.

On April 26, 2005, we acquired certain assets of Pike Street Industries, which was incorporated in Washington on March 6, 2002.

On July 27, 2005, we acquired IndustryBrains, which was incorporated in New York on January 31, 2002.

On May 1, 2006, we acquired certain assets of AreaConnect, which was formed in Delaware on June 5, 2002.

On May 26, 2006, we acquired certain assets of Open List, which was incorporated in Delaware on November 18, 2003.

We currently have offices in Seattle, Washington; Orem, Utah; Eugene, Oregon; Las Vegas, Nevada; and New York City, New York.

Acquisitions

We have completed the following acquisitions during 2004, 2005 and 2006 which have been accounted for as business combinations.

goClick

In July 2004, we acquired goClick, a company focused on providing marketing technology and services for small merchants, for the following consideration:

$7.5 million in net cash and acquisition costs; plus

433,541 shares of Class B common stock.

The shares of Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately $4.14 million.

Name Development

In February 2005, we acquired substantially all of the assets of Name Development, a corporation operating in the direct navigation market, for the following consideration:

$155.6 million in cash and acquisition costs; plus

419,659 shares of Class B common stock.

Table of Contents

The shares of Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately $8.8 million.

Under the terms of the agreement, we acquired certain assets of Name Development, including its portfolio of Internet domains and Web sites, revenue-generating contracts, technology and systems for the operation of the Name Development direct navigation business. We did not assume any other obligations with respect to Name Development as part of this asset acquisition.

Pike Street Industries

In April 2005, we acquired certain assets of Pike Street, an online yellow pages and lead generation provider for local merchants, for the following consideration:

- $12.8 million in cash and acquisition costs; plus
- 242,748 shares of Class B common stock; plus
- 212,404 shares of restricted Class B common stock which will vest over a three year period in installments of 16.67% after each six month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $4.1 million.

The shares of restricted Class B common stock were issued to employees of Pike Street and valued at approximately $3.6 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

We did not assume any other obligations with respect to Pike Street as part of this asset acquisition.

IndustryBrains

In July 2005, we acquired IndustryBrains, a company focused on monetizing Web sites through contextual advertising solutions, for the following consideration:

- $16.1 million in net cash and acquisition costs; plus
- 788,046 shares of Class B common stock; plus
- 176,909 shares of restricted Class B common stock which will vest over a two and one half year period in installments of 33.34% after each ten month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $13.4 million.

The shares of restricted Class B common stock were issued to employee shareholders of IndustryBrains and valued at approximately $3.0 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

AreaConnect

In May 2006, we acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers, for the following consideration:

- $12.2 million in cash and estimated acquisition costs; plus
- 183,832 shares of Class B common stock; plus
- 78,129 shares of restricted Class B common stock that vest over a period of 3 years.

Table of Contents

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $3.9 million.

The shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company and were valued at approximately $1.7 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

We did not assume any other obligations with respect to AreaConnect as part of this asset acquisition.

Open List

In May 2006, we acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform, for the following consideration:

- $6.3 million in cash and estimated acquisition costs; plus
- 286,254 shares of Class B common stock; plus
- 114,502 shares of restricted Class B common stock that vest over a two and one-half year period from the closing date in installments of 20% after each six month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately $5.0 million.

The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company and were valued at approximately $2.0 million, which is recorded as compensation expense over the associated employment period during which these shares vest.

We did not assume any other obligations with respect to Open List as part of this asset acquisition.

Consolidated Statements of Operations

The assets, liabilities and operations of our acquisitions are included in our consolidated financial statements as of the date of the respective acquisitions.

All significant inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on the respective acquisition dates. All goodwill, intangible assets and liabilities resulting from the acquisitions have been recorded in our financial statements.

Presentation of Financial Reporting Periods

The comparative periods presented are for the years ended December 31, 2004, 2005 and 2006.

Revenue

We currently generate revenue through our suite of services, including our contextual targeting, pay-per-click targeting, feed management, bid management, natural search optimization and outsourced search marketing services platforms.

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services, cost-per-action services and feed management services. These primary sources amounted to greater than 91% of our revenues in all periods presented. Our secondary sources of revenue are our bid campaign

management services, natural search optimization services and outsourced search marketing platforms. These secondary sources amounted to less than 9% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on the related receivables may vary from reported information based upon third party refinement of the estimated and reported amounts owing that occurs subsequent to period ends.

Performance-Based Advertising Services

In providing contextual targeting services, merchant advertisers purchase keywords or keyword strings, based on an amount they choose for a targeted placement on vertically-focused Web sites or specific pages of a Web site that are specific to their products or services and their marketing objectives. The contextual results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant s advertisement and the relevance of the merchant s advertisement, which is dictated by historical click-through rates. Merchant advertisers pay us when a click-through occurs on their advertisement.

In providing pay-per-click advertising services, we generate revenue upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers listings. These merchant advertisers and advertising service providers pay us a designated transaction fee for each click-through, which occurs when an online user clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes search engines, directories, destination sites, third-party Internet domains or Web sites, our portfolio of owned Web sites and other targeted Web-based content. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to a merchant advertiser Web site and completes the specified action.

In providing feed management services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included in search engine, directory and product shopping engine results within our distribution network. Generally, the feed management listings are presented in a different section of the Web page than the pay-per-click listings. For this service, revenue is generated when an online user clicks on a feed management listing from search engine, directory or product shopping engine results. Each click-through on an advertisement listing represents a completed transaction for which the merchant advertiser pays for on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

Search Marketing Services

Merchant advertisers pay us additional fees for services such as bid management and natural search engine optimization. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers. We may also charge initial set-up, account, service or inclusion fees as part of our services.

Banner advertising revenue may be based on a fixed fee per click and is generated and recognized on click-through activity. In other cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

Non-refundable account set-up fees are paid by merchant advertisers and are recognized ratably over the longer of the term of the contract or the average expected merchant advertiser relationship period, which

Table of Contents

generally ranges from twelve months to more than two years. Other account and service fees are recognized in the month or period the account fee or services relate to.

Other inclusion fees are generally associated with monthly or annual subscription-based services where a merchant advertiser pays a fixed amount to be included in our index of listings or our distribution partners index of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

Outsourced Search Marketing Platforms

We generate revenue from super-aggregator partners and publishers utilizing our web-based technologies. We are paid a management or agency fee based on the total amount of the purchase made by the merchant advertiser. The partners or publishers engage the merchant advertisers and are the primary obligor, and we, in certain instances, are only financially liable to the publishers in our capacity as a collection agency for the amount collected from the merchant advertisers. We recognize revenue for these fees under the net revenue recognition method.

Industry and Market Factors

We enter into agreements with various distribution partners to provide distribution for the URL strings and advertisement listings of our merchant advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount per click-through on these listings. The level of click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. Our current growth will be impacted by our ability to increase our distribution, which impacts the number of Internet users who have access to our merchant advertisers listings and the rate at which our merchant advertisers are able to convert clicks from these Internet users into completed transactions, such as a purchase or sign up. Our current growth also depends on our ability to continue to increase the number of merchant advertisers who use our services and the amount these merchant advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular, it is difficult to project the number of click-throughs we will deliver to our merchant advertisers and how much merchant advertisers will spend with us, and it is even more difficult to anticipate the average revenue per click-through.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage and seasonal purchasing cycles of many merchant advertisers. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results.

Service Costs

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

- user acquisition costs;
- amortization and impairment of intangible assets;
- license and content fees;
- credit card processing fees;

network operations;

serving our search results;

Table of Contents

- maintaining our Web sites;
- domain name registration renewal fees;
- network fees;
- fees paid to outside service providers;
- delivering customer service;
- depreciation of our Web sites, network equipment and internally developed software;
- colocation service charges of our Web site equipment;
- bandwidth and software license fees;
- salaries of related personnel; and
- stock-based compensation of related personnel.

User Acquisition Costs

For the periods presented the largest component of our service costs consist of user acquisition costs that relate primarily to payments made to distribution partners for access to their online user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their Web sites and indexes. The primary economic structure of the distribution partner agreements is a variable payment based on a specified percentage of revenue.

These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that to a lesser degree exist include:

- fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid click-throughs; and
- a combination arrangement with both fixed and variable amounts that may be paid in advance.

We expense user acquisition costs based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed as the greater of: (1) pro-rata over the term the fixed payment covers; or (2) usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payments based on a percentage of revenue, number of paid click-throughs or other metrics are expensed as incurred based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Sales and Marketing

Sales and marketing expenses consist primarily of:

- payroll and related expenses for personnel engaged in marketing and sales functions;
- advertising and promotional expenditures including online and outside marketing activities;
- cost of systems used to sell to and serve merchant advertisers; and
- stock-based compensation of related personnel.

Product Development

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Web sites and services.

Table of Contents

Our research and development expenses include:

- compensation and related expenses;
- costs of computer hardware and software;
- costs incurred in developing features and functionality of the services we offer; and
- stock-based compensation of related personnel.

For the periods presented, substantially all of our product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with the American Institute of Certified Public Accountants Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

General and Administrative

General and administrative expenses consist primarily of:

- payroll and related expenses for executive and administrative personnel;
- professional services, including accounting, legal and insurance;
- bad debt provisions;
- facilities costs;
- other general corporate expenses; and
- stock-based compensation of related personnel.

Acquisition-Related Retention Consideration

Acquisition-related retention consideration results from our contingent, earnings-based payment obligation to certain employees of Enhance Interactive for 2004, pursuant to the terms of the merger agreement.

The contingent payment obligation was calculated based on the formula of 5.56% of Enhance Interactive s earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of $1.0 million in the aggregate. All payments made under this obligation have been accounted for as compensation. For the year ended December 31, 2004, we recorded $499,000 in acquisition-related retention consideration. Subsequent to December 31, 2004, no additional obligations exist related to the acquisition-related retention consideration.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for stock-based compensation under APB 25 and used the intrinsic value method. In accordance with APB 25, stock-based compensation consisted of the following:

- the intrinsic value of employee option and restricted stock issuances in cases where the fair value of the underlying stock was greater than the exercise price on the date of the grant;
- the fair value of non-employee option issuances; and
- the amount by which the fair value of our Class B common stock exceeds the exercise price at the end of the period for certain options.

Table of Contents

We used variable accounting for the options to purchase 125,000 shares of our Class B common stock that were issued under our stock incentive plan pursuant to the Enhance Interactive merger agreement. These options were held in escrow until February 28, 2004 as security for the indemnification obligations under the Enhance Interactive merger agreement, and these options were subject to forfeiture during the escrow period. We accounted for these options as variable awards until February 28, 2004.

As of January 1, 2006, we adopted SFAS 123R and account for stock-based compensation under the fair value method. As a result, stock-based compensation consists of the following:

- all share-based compensation arrangements granted after January 1, 2006 and for any such arrangements that are modified, cancelled, or repurchased after that date, and

- the portion of previous share-based awards for which the requisite service has not been rendered as of that date, based on the grant-date estimated fair value of those awards estimated in accordance with the pro forma provisions of SFAS 123.

As we adopted SFAS 123R using the modified prospective method, the results for the prior year have not been restated under the fair value method for GAAP purposes.

Stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations in accordance with SAB 107. Stock-based compensation expense recognized in the prior period has been reclassified to conform to the presentation in the current period.

Amortization of Intangibles from Acquisitions

Amortization of intangible assets excluding goodwill relates to intangible assets identified in connection with our acquisitions.

The intangible assets have been identified as:

- non-competition agreements;

- trade and Internet domain names;

- distributor relationships;

- merchant advertising customer base relationships; and

- acquired technology.

These assets are amortized over useful lives ranging from 12 to 84 months.

Provision for Income Taxes

For income tax purposes, we utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized. Although realization is not assured, we believe it is more likely than not, based on its operating performance and projections of future taxable income, that our net deferred tax assets, excluding certain state net operating loss carryforwards, will be realized. In determining that it was more likely than not that we would realize the deferred tax assets, factors considered included: historical taxable income, historical trends related to merchant advertiser usage rates and projected revenues and expenses. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if our projections of future taxable income are reduced or if we do not perform at the levels we are projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets. From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of us and our filings. We believe any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

As of December 31, 2005 and 2006, we had federal net operating loss, or NOL, carryforwards of $1.7 million for both periods which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that the utilization of the approximately $1.7 million of NOL carryforwards is limited such that substantially all of these federal NOL carryforwards will never be utilized.

As of December 31, 2005 and 2006, we had certain tax effected state net operating loss carryforwards of approximately $395,000 and $1.0 million, respectively. We do not have a history of taxable income in the relevant state and the state net operating loss carryforwards will more likely than not expire unutilized. Therefore, we have recorded a 100% valuation allowance on the state net operating loss carryforwards as of December 31, 2005 and 2006.

Initial Public Offering

On March 30, 2004, we commenced an initial public offering of 4.6 million shares of our Class B common stock. The closing of our initial public offering took place on April 5, 2004. The proceeds of our initial public offering, net of cash offering expenses, were approximately $27.2 million. In connection with our initial public offering, the underwriters were also granted warrants, exercisable over a four-year period commencing April 5, 2005 and ending April 5, 2009, to purchase 120,000 shares of Class B common stock at an exercise price equal to $8.45 per share. All of the net proceeds have been used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations, working capital and other general corporate purposes.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock

All 6,724,063 shares of our outstanding Series A redeemable convertible preferred stock were automatically converted into 6,724,063 shares of Class B common stock upon the closing of our initial public offering in April 2004. Prior to this conversion, holders of our Series A redeemable convertible preferred stock were entitled to receive annual cumulative dividends at the per annum rate of 8% of the original purchase price per share when and if declared by our board of directors. Upon the conversion of the Series A redeemable convertible preferred stock, dividend rights were automatically terminated and any rights to past dividends were forgiven.

Prior to the automatic conversion, we accounted for the difference between the carrying amount of the redeemable preferred stock and the redemption amount by increasing the carrying amount for periodic accretion using the interest method, so that the carrying amount was equal to redemption amount at the earliest redemption date.

Follow-on Public Offering

In February 2005, we closed a follow-on public offering of 9,200,000 shares of Class B common stock at a public offering price of $20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of $250 per share and with a liquidation preference of $250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of $12.2 million, were approximately $174.1 million and $55.3 million, respectively, for an aggregate amount of $229.4 million. All of the net proceeds have been used to fund the Name

Table of Contents

Development and Pike Street Industries asset acquisitions, and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006, and for working capital and other general corporate purposes.

Holders of the preferred stock are entitled to receive cumulative dividends from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.

During 2005 and 2006, the Company s board of directors declared the following quarterly dividends on the Company s 4.75% convertible exchangeable preferred stock:

Approval Date	Per share dividend	Date of record	Total amount (in thousands)	Payment date
April 2005	$ 3.00	May 4, 2005	$ 690	May 16, 2005
July 2005	2.97	August 4, 2005	683	August 15, 2005
October 2005	2.97	November 4, 2005	683	November 15, 2005
January 2006	2.97	February 4, 2006	662	February 15, 2006
April 2006	2.97	May 4, 2006	422	May 15, 2006
July 2006	2.97	August 4, 2006	422	August 15, 2006
October 2006	2.97	November 4, 2006	422	November 15, 2006

In January 2007, the Company s board of directors declared a quarterly dividend in the amount of $2.97 per share on its 4.75% convertible exchangeable preferred stock which was paid on February 15, 2007 to the holders of record as of the close of business on February 2, 2007. This quarterly dividend totaled approximately $21,000.

The preferred stock is convertible at the option of the holder at any time into shares of Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of $24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change. During 2005, 4,515 shares of preferred stock were converted at the option of the holders into 46,071 shares of the Company s Class B common stock at a conversion price of $24.50 per share. In January 2006, 2,500 shares of preferred stock were converted at the option of the holders into 25,510 shares of the Company s Class B common stock at a conversion price of $24.50 per share. In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted 80,848 shares of the Company s preferred stock into 824,980 shares of the Company s Class B common stock at a conversion rate of $24.50 per share and received a cash payment from the Company of $12.00 per share of preferred stock for an aggregate amount of approximately $970,000 in order to induce conversions. The $970,000 was reflected as preferred stock dividends and conversion payment in the Company s financial statements. In December 2006, the Company repurchased an aggregate of 132,379 shares of preferred stock outstanding at a price of $195.00 per share (plus commissions), representing a total cash expenditure of approximately $26.0 million. In 2007, the Company repurchased an additional 2,825 shares of preferred stock for a total cash expenditure of $555,000. Through March 16, 2007, approximately 6,933 shares of preferred stock remain outstanding following the conversions and cash repurchases.

We may elect to automatically convert some or all of the preferred stock into shares of Class B common stock if the closing price of our Class B common stock has exceeded $36.75, which is 150% of the conversion price for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.

If we elect to automatically convert some or all of the preferred stock into shares of Class B common stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from

Table of Contents

February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of Class B common stock.

We may elect to redeem the preferred stock, in whole or in part, at declining redemption prices on or after February 20, 2008.

The terms of the preferred stock contain an exchange right, at our option, to convert the preferred stock, in whole but not in part, on any dividend payment date beginning on February 15, 2006 into our 4.75% convertible subordinated debentures (Debentures) at the rate of $250 principal amount of Debentures for each share of preferred stock. This embedded derivative will be reflected as an asset, if there is any value ascribed to it, and is subject to variable accounting. The right will be marked to market at each reporting date until such time as the right is exercised or expires. Based on a variety of factors including the assessed probability of exercise, no value has been ascribed to this right as of December 31, 2006. The Debentures, if issued, will mature 25 years after the exchange date.

Comparison of the periods of the year ended December 31, 2005 (2005) to the year ended December 31, 2006 (2006) and comparison of the periods of the year ended December 31, 2004 (2004) to the year ended December 31, 2005 (2005).

Revenue. The following table presents our revenues, by revenue source, for the periods presented:

	Years ended December 31,		
	2004	**2005**	**2006**
Proprietary Traffic Sources	$	$ 27,063,459	$ 47,735,446
Partner and Other Revenue Sources	43,804,272	67,932,387	80,024,029
Total Revenue	$ 43,804,272	$ 94,995,846	$ 127,759,475

Our proprietary traffic revenues are generated from our portfolio of owned Web sites which are monetized with pay-per-click and cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of our owned and operated Web sites and clicks on a particular listing or completes the specified action, we receive a fee.

Our partner network revenues are primarily generated using third-party distribution networks to deliver the merchant advertisers listings. The distribution network includes search engines, shopping engines, directories, destination sites, third-party Internet domains or Web sites, and other targeted Web-based content. We generate revenue upon delivery of qualified and reported click-throughs to our merchant advertisers or to advertising services providers listings. We pay a revenue share to the distribution partners to access their online user traffic. Other revenues include our bid management services, natural search optimization services and outsourced search marketing platforms.

Revenue increased 35%, from $95.0 million in 2005 to $127.8 million in 2006. This increase was attributable to a $28.1 million increase in performance-based advertising services. Of this increase, a substantial majority related to an increase in the average revenue per merchant advertiser, while the remaining related to an increase in the number of merchant advertisers. Of the total revenue increase, $20.7 million is derived from our proprietary traffic revenues which are attributable to our portfolio of more than 200,000 Web sites. The majority of the revenues from our proprietary traffic are attributable to the Name Development and Pike Street asset acquisitions in 2005 and the AreaConnect and Open List asset acquisitions in 2006, including their respective portfolios of Web sites.

Table of Contents

We believe the increase in revenue is primarily a result of the growth of our existing distribution partners and proprietary traffic sources, the increased number of searches and resulting click-throughs performed by users of our services, and new merchant advertisers and advertising services provider relationships. We also believe the foregoing factors, combined with our sales efforts have contributed to an increase in the average revenue per merchant advertiser. The increase in revenue in 2006 is also attributable to the acquisition of IndustryBrains in July 2005 which added more than 100 unique distribution partners and more than 1,000 unique merchant advertisers and the May 2006 AreaConnect asset acquisition.

Revenue increased 117%, from $43.8 million in 2004 to $95.0 million in 2005. This increase was attributable to a $47.9 million increase in performance-based advertising services. Of this increase, more than 70% related to an increase in the average revenue per merchant advertiser, while the remaining related to an increase in the number of merchant advertisers. Approximately $21.7 million of the increase in the average revenue per merchant advertiser was due to an advertising services provider relationship initiated in 2005. Of the total revenue increase, $27.1 million is derived from our proprietary traffic revenues which are attributable to our portfolio of more than 200,000 Web sites which includes the Name Development and Pike Street asset acquisitions and their respective portfolios of more than 100,000 Internet Web sites. Of the total increase in revenue, $4.9 million was indirectly attributable to the acquisition of IndustryBrains in July 2005 and its merchant advertisers.

Our ability to maintain and grow our revenues will depend in part on maintaining and increasing the number of click-throughs performed by users of our service, primarily through our distribution partners. If we do not add new distribution partners, renew our current distribution partner agreements or replace traffic lost from terminated distribution agreements with other sources or if our distribution partners search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our ability to maintain and grow our revenues will also depend in part on maintaining and growing our proprietary traffic sources and also maintaining and increasing the number and volume of transactions and favorable variable payment terms with merchant advertisers and advertising services providers, which we believe is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers and advertising services providers.

Expenses

Expenses were as follows:

	Years ended December 31,					
	2004	**% of revenue**	**2005**	**% of revenue**	**2006**	**% of revenue**
Service costs	27,460,738	63%	48,901,826	51%	60,433,611	47%
Sales and marketing	4,569,777	10%	11,127,037	12%	23,050,654	18%
Product development	2,351,313	5%	4,494,558	5%	10,094,967	8%
General and administrative	4,775,647	11%	7,194,905	8%	13,533,215	11%
Amortization of acquired intangible assets	4,965,503	11%	18,429,008	19%	20,465,128	16%
Acquisition-related retention consideration	499,080	1%		0%		0%
Facility relocation	199,960	0%		0%		0%

Effective January 1, 2006, we adopted SFAS 123R and record stock-based compensation expense under the fair value method. Prior to January 1, 2006, we accounted for stock-based compensation under APB 25 and used the intrinsic value method. In 2006, we recorded $12.8 million of stock-based compensation expense as compared to $2.0 million in 2005 and $891,000 in 2004. This stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations in accordance with SAB 107. Stock-based compensation recognized in the prior periods has been reclassified to conform to the presentation in the current period.

Stock-based compensation expense was included in the following operating expense categories as follows:

	Years ended December 31,		
	2004	2005	2006
Service costs	$ 10,800	$ 4,500	$ 1,177,773
Sales and marketing	155,734	1,108,180	2,996,945
Product development	59,883	28,795	3,278,513
General and administrative	664,103	830,332	5,338,287
Total stock-based compensation	$ 890,520	$ 1,971,807	$ 12,791,518

See Note 6 (d) Stock Option Plan of the consolidated financial statements as well as our Critical Accounting Policies for additional information about stock-based compensation.

Service Costs. Service costs increased 24% from $48.9 million in 2005 to $60.4 million in 2006. The increase was attributable to an increase in payments to distribution partners of $5.9 million which in part was attributable to the acquisition of IndustryBrains in July 2005, an increase in personnel costs of $2.6 million of which $1.2 million was related to stock-based compensation expense, an increase in payment processing fees of $221,000, an increase in facility and other costs of $1.2 million, and an increase in registration fees and Internet domain amortization of $1.7 million. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006.

This total increase also resulted from a greater number of searches, an increase in database and hardware capacity requirements, an increase in the number of personnel required to support our services and an increase in fees paid to outside service providers.

Service costs increased 78% from $27.5 million in 2004 to $48.9 million in 2005. The increase was mainly attributable to an increase in payments to distribution partners of $14.9 million, an increase in personnel costs of $807,000, an increase in payment processing fees of $420,000, an increase in facility and other costs of $458,000, an increase in licenses and royalties of $2.3 million in connection with the 2005 Name Development asset acquisition in which we entered into a new licensing partner agreement (see Note 4 (a) Commitments), and an increase in registration fees and Internet domain amortization of $2.5 million.

Service costs represented 47% of revenue in 2006 compared to 51% in 2005 and 63% of revenue in the 2004. The 2006 decrease as percentage of revenue in service costs as compared to 2005 was primarily a result of a larger proportion of revenue attributable to our proprietary traffic sources for which there are no corresponding distribution partner payments. The 2005 decrease as a percentage of revenue in service costs as compared to 2004 was also primarily a result of a larger proportion of revenue attributable to our proprietary traffic sources for which there are no corresponding distribution partner payments. Payments to feed management and pay-per-click distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage. We expect that user acquisition costs and revenue shares to distribution partners are likely to increase prospectively given the competitive landscape for distribution partners. To the extent that payments to feed management and pay-per-click services distribution partners make up a larger percentage of future operations, or the addition or renewal of existing distribution partner agreements are on terms less favorable to us, we expect that service costs will increase as a percentage of revenue. Our proprietary traffic sources have a lower service cost as a percentage of revenue relative to our overall service cost percentage. To the extent our proprietary traffic sources make up a larger percentage of our future operations, we expect that service costs will decrease as a percentage of revenue. We also expect that service costs will continue to increase in absolute dollars as a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006 and costs associated with the expansion of our operations.

Sales and Marketing. Sales and marketing expenses increased 107%, from $11.1 million in 2005 to $23.1 million in 2006. As a percentage of revenue, sales and marketing expenses were 12% and 18% for 2005 and 2006, respectively. The increase in dollars was related primarily to an increase in personnel costs of $2.3 million of which $1.9 million was related to stock-based compensation and the remaining amount was primarily related to an increase in the number of employees and an increase in online and outside marketing activities of $9.5 million. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006. The remaining increase is related to increases in other operating costs arising from operations in multiple jurisdictions. We expect that sales and marketing expenses will increase in absolute dollars as a result of additional stock-based compensation expense due to our adoption of SFAS 123R and in connection with any revenue increase to the extent that we also increase our marketing activities and correspondingly could increase as a percentage of revenue.

Sales and marketing expenses increased 143%, from $4.6 million in 2004 to $11.1 million in 2005. As a percentage of revenue, sales and marketing expenses were 10% and 12% for the 2004 and 2005, respectively. The increase in dollars was related primarily to an increase in personnel costs of $2.4 million of which $952,000 was related to stock-based compensation and the remaining amount was primarily due to an increase in the number of employees and an increase in online and outside marketing activities of $3.9 million. The remaining increase is related to increases in other operating costs arising from operations in multiple jurisdictions.

Product Development. Product development expenses increased 125%, from $4.5 million in 2005 to $10.1 million in 2006. As a percentage of revenue, product development expenses were 5% and 8% for 2005 and 2006, respectively. The increase in dollars was primarily due to an increase in personnel costs of $5.1 million of which $3.2 million was related to stock-based compensation expense and the remaining amount was primarily related to an increase in the number of employees, and travel, depreciation expense, and other operating costs of $483,000. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006. We expect that product development expenses will increase in absolute dollars as we increase the number of personnel and consultants to enhance our service offerings and as a result of additional stock-based compensation expense due to our adoption of SFAS 123R.

Product development expenses increased 91%, from $2.4 million in 2004 to $4.5 million in 2005. As a percentage of revenue, product development expenses were 5% for both 2004 and 2005, respectively. The increase in dollars was primarily due to an increase in personnel costs of $1.7 million, primarily related to an increase in the number of employees, and travel, depreciation expense, and other operating costs of $440,000.

General and Administrative. General and administrative expenses increased 88%, from $7.2 million in 2005 to $13.5 million in 2006. The increase in dollars was primarily due to an increase in personnel costs of $5.3 million of which $4.5 million was related to stock-based compensation, an increase in professional services of $203,000, an increase in facilities related costs of $133,000, and by a net increase in travel, bad debt, and other costs of $719,000. As a percentage of revenue, general and administrative expenses were 8% and 11% for 2005 and 2006, respectively. As a percentage of revenue, the increase in general and administrative expenses in 2006 as compared to 2005 was primarily a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006. We expect that our general and administrative expenses will increase in absolute dollars as a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006 and to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance.

General and administrative expenses increased 51%, from $4.8 million in 2004 to $7.2 million in 2005. The increase in dollars was primarily due to an increase in personnel costs and stock-based compensation of $1.5 million, an increase in professional services of $409,000, an increase in facilities related costs of $344,000, and by a net increase in travel, bad debt, and other costs of $164,000. As a percentage of revenue, general and administrative expenses were 11% for 2004 and 8% in 2005. As a percentage of revenue, the decrease in general and administrative expenses in 2005 as compared to 2004 was primarily a result of general and administrative expenses being compared to a larger revenue base.

Amortization of Intangible Assets From Acquisitions. Intangible amortization expense increased 11%, from $18.4 million in 2005 to $20.5 million in 2006. The increase was associated with the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition during 2005 and the AreaConnect and Open List asset acquisitions in May 2006. During the 2006 period, the components of amortization of intangibles were service costs of $13.9 million, sales and marketing of $2.6 million and general and administrative of $3.9 million.

Intangible amortization expense increased 271%, from $5.0 million in 2004 to $18.4 million in 2005. The increase was associated with the July 2004 acquisition of goClick, the February 2005 Name Development asset acquisition, the April 2005 Pike Street asset acquisition and the July 2005 acquisition of IndustryBrains. During the 2005 period, the components of amortization of intangibles were service costs of $13.8 million, sales and marketing of $1.3 million and general and administrative of $3.4 million.

Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on their respective acquisition dates. All goodwill, identifiable intangible assets and liabilities resulting from our acquisitions have been recorded in our financial statements. The identified intangibles amounted to $77.6 million and $82.2 million at December 31, 2005 and 2006, respectively, and are being amortized over a range of useful lives of 12 to 84 months. We may acquire identifiable intangible assets as part of future acquisitions, and if so, we expect that our intangible amortization will increase in absolute dollars.

Acquisition-Related Retention Consideration. Acquisition-related retention consideration was $499,000 in 2004 and $0 in 2005 and 2006. The acquisition related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and was equal to 5.56% of Enhance Interactive s earnings before taxes in excess of $3.5 million for 2004 of which $499,000 was recorded as acquisition-related retention consideration including employer payroll-related taxes. We had accounted for the payment amount as compensation. Subsequent to December 31, 2004, no additional obligations exist related to the acquisition-related retention consideration.

Facility Relocation. In March 2004, we entered into a sublease agreement for new and larger office facilities in Seattle, Washington, and we relocated from our original office facilities also located in Seattle, Washington. In March 2004, we accrued lease and related costs of $230,000 for the estimated future obligations of non-cancelable lease and other payments for the original facilities. The remaining lease obligations for the original facilities extended through June 30, 2006. As of December 31, 2006, there is no remaining lease obligation for the original office facilities.

The remaining lease accrual was based on estimates of vacancy period and sublease income. The remaining lease accrual at December 31, 2005 and 2006 was $32,000 and $0.

Gain (loss) on sales and disposals of intangible assets, net. The gain (loss) on sales and disposals of intangible assets, net was $370,000 in 2006 and was attributable to the sales and disposals of Internet domain name intangible assets. During 2005, we had minimal sales and disposals of Internet domain name intangible assets and there was no comparable gain (loss) in 2004.

Other Income. Other income increased 59%, from $2.0 million in 2005 to $3.1 million in 2006. The increase was primarily attributable to an increase in interest income of $1.2 million which was primarily a result of an increase in rates realized on invested funds.

Table of Contents

Other income increased 521%, from $319,000 in the 2004 to $2.0 million in 2005. The increase was primarily attributable to an increase in interest income of $1.7 million which was primarily a result of the impact of our follow-on public offering in February 2005 on the average cash balances in the 2005 as well as an increase in rates realized on invested funds.

Income Taxes. The income tax expense in 2005 was $2.9 million compared to $4.3 million in 2006. In 2005, the effective tax rate of 43% differed from the expected effective tax rate of 35% primarily due to state income taxes and non-deductible stock compensation amounts recorded under the intrinsic-value based accounting prescribed by APB 25 in which stock-based compensation was recorded only if, on the date of grant, the current market price of our Class B common stock exceeded the exercise price. In 2006, the effective tax rate of 116% differed from the expected tax rate of 35% due to non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method as prescribed by SFAS 123R, state income taxes, and other amounts.

The income tax expense in 2004 was $34,000 compared to $2.9 million in 2005. The increase in income taxes was primarily the result of pretax income of $6.8 million in 2005 compared to a pretax loss of $700,000 in 2004. In 2004, the effective tax benefit of 5% differed from the expected effective rate of 34% primarily due to state income taxes and non-deductible stock compensation amounts.

During 2004, 2005 and 2006, as a result of tax deductions from stock option exercises, we recognized tax-effected benefits of approximately $444,000, $3.2 million and $2.6 million, respectively, which were recorded as credits to additional paid in capital.

Cumulative effect of Change in Accounting Principle. In 2006, a one-time gain of $151,000, net of tax, was recognized as an cumulative effect of a change in accounting principle based on SFAS 123R s requirement to apply an estimated forfeiture rate to unvested awards. Previously, forfeitures had been recorded as incurred.

Convertible Preferred Stock Dividends, Conversion Payment, and Discount on Preferred Stock Redemption, net. In 2006, there was $1.6 million of convertible preferred stock dividends and a one time payment of approximately $970,000 associated with the voluntary conversion of 80,848 shares of our preferred stock into 824,980 shares of our Class B common stock in March 2006 net of a $5.8 million discount on preferred stock redemption in connection with our repurchase of an aggregate of 132,379 shares of preferred stock outstanding at a price of $195.00 per share (plus commission).

The convertible preferred stock dividends decreased 34%, from $2.4 million in 2005 to $1.6 million in 2006. The decrease was primarily attributable to the reduction of outstanding preferred stock from the voluntary conversion of 80,848 shares in March 2006 and the preferred stock repurchase of 132,379 shares in December 2006. The convertible preferred stock dividends in 2005 and 2006 are based upon the convertible preferred shares with a dividend rate of 4.75% issued in February 2005 net of conversions during the period.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock. The accretion to redemption value of preferred stock was $420,000 in 2004 and $0 in 2005 and 2006. The accretion to the redemption value recorded during the 2004 is based upon 6,724,063 shares of Series A redeemable convertible preferred stock outstanding as of April 5, 2004 with a dividend rate of 8% per annum. All 6,724,063 shares of Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock upon the closing of the initial public offering on April 5, 2004.

Net Income (Loss) Applicable to Common Stockholders. The net income applicable to common stockholders increased from $1.5 million in 2005 to $2.8 million in 2006. The increase was primarily attributable to the $5.8 million discount of preferred stock redemption. The net income applicable to common stockholders would be a net loss of $3.0 million excluding the effect of the discount of preferred stock redemption. Comparing net income (loss) in 2005 to 2006 excluding the effect of the discount of preferred stock redemption, net income decreased

Table of Contents

$4.5 million. The decrease was primarily attributable to an increase in stock-based compensation expense of $10.8 million due to our adoption of SFAS 123R in 2006, an increase in income tax expense of $1.4 million, and an increase of amortization of intangible assets from acquisitions of $2.0 million due primarily to the May 2006 AreaConnect and Open List asset acquisitions, offset by revenue increasing at a faster rate than service costs, sales and marketing, product development and general administration expenses excluding stock-based compensation expense, a one-time gain of $151,000 as a cumulative effect of a change in accounting principle, an increase in interest income of $1.2 million, and gain (loss) on sales and disposals of intangible assets, net of $369,000.

Net income (loss) applicable to common stockholders increased from a net loss of $1.2 million in 2004 to a net income of $1.5 million in 2005. The increase was primarily attributable to revenue increasing at a faster rate than service costs, sales and marketing, product development and general and administration expenses offset by convertible preferred dividends of $2.4 million. There was also a decrease in acquisition-related retention consideration of $499,000 and facility relocation of $200,000.

Quarterly Results of Operations

The following tables set forth our unaudited quarterly results of operations data for the eight most recent quarters ended December 31, 2006, as well as such data expressed as a percentage of our revenues for the periods presented. The information in the tables below should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this report. We have prepared this information on the same basis as the consolidated financial statements and the information includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for the quarters or other periods presented. Our quarterly operating results have varied substantially in the past and may vary substantially in the future. You should not draw any conclusions about our future results from the results of operations for any particular quarter or period presented.

Table of Contents

	Quarter ended							
	Mar 31, 2005	**June 30, 2005**	**Sept 30, 2005**	**Dec 31, 2005**	**Mar 31, 2006**	**June 30, 2006**	**Sept 30, 2006**	**Dec 31, 2006**
Consolidated Statement of Operations:								
Revenue	$ 18,395,983	$ 21,168,022	$ 25,627,677	$ 29,804,165	$ 31,112,325	$ 31,714,720	$ 32,326,116	$ 32,606,314
Expenses:								
Service costs (1), (2)	10,670,707	10,871,462	13,280,344	14,079,313	14,851,949	15,020,319	15,184,125	15,377,218
Sales and marketing (1), (2)	1,354,493	1,829,819	3,197,809	4,744,916	5,866,684	5,407,200	5,962,465	5,814,305
Product development (1), (2)	785,214	1,428,530	1,038,257	1,242,557	2,227,024	2,553,395	2,689,912	2,624,636
General and administrative (1), (2)	1,556,600	1,413,987	1,870,984	2,353,334	3,409,508	3,846,212	3,109,209	3,168,286
Amortization of intangible assets from acquisitions (3)	3,083,157	4,949,651	5,191,699	5,204,501	4,870,673	5,164,191	5,309,102	5,121,162
Total operating expenses	17,450,171	20,493,449	24,579,093	27,624,621	31,225,838	31,991,317	32,254,813	32,105,607
Gain on sales of intangible assets, net				997	179,208	174,071	(68,513)	85,194
Income (loss) from operations	945,812	674,573	1,048,584	2,180,541	65,695	(102,526)	2,790	585,901
Other income (expense):								
Interest income	268,383	587,973	533,976	591,890	738,356	754,054	831,005	837,604
Interest expense	(1,860)	(1,600)	(1,933)	(2,070)	(2,211)	(2,228)	(1,841)	(2,012)
Other	4,000				(1,863)		(7,901)	400
Total other income	270,523	586,373	532,043	589,820	734,282	751,826	821,263	835,992
Income before provision for income taxes	1,216,335	1,260,946	1,580,627	2,770,361	799,977	649,300	824,053	1,421,893
Income tax expense	478,933	470,656	871,277	1,099,597	653,648	838,804	812,795	1,984,954
Income (loss) before cumulative effect of change in accounting principle	737,402	790,290	709,350	1,670,764	146,329	(189,504)	11,258	(563,061)
Cumulative effect of change in accounting principle, net					151,341			
Net income (loss)	737,402	790,290	709,350	1,670,764	297,670	(189,504)	11,258	(563,061)
Convertible preferred stock dividends, conversion payment and discount on preferred stock redemption, net (4)	348,993	682,813	682,813	691,161	1,493,935	422,147	422,147	(5,535,570)
Net income (loss) applicable to common stockholders	$ 388,409	$ 107,477	$ 26,537	$ 979,603	$ (1,196,265)	$ (611,651)	$ (410,889)	$ 4,972,509

(1) Excludes acquisition-related consideration and amortization of intangible assets from acquisitions.

(2) Includes stock-based compensation as follows:

Service costs	$ 1,800	$ 132,834	$ (131,034)	$ 900	$ 236,211	$ 255,742	$ 268,654	$ 417,166
Sales and marketing	29,507	285,924	437,983	354,766	1,047,271	943,978	845,594	160,102
Product development	10,665	137,985	(125,895)	6,040	735,187	827,187	884,156	831,983
General and administrative	104,566	(59,574)	376,904	408,436	1,502,074	1,401,001	1,210,301	1,224,911
Total	$ 146,538	$ 497,169	$ 557,958	$ 770,142	$ 3,520,743	$ 3,427,908	$ 3,208,705	$ 2,634,162

Stock-based compensation recognized in each of the four quarters in 2005, accounted for under APB 25, has been reclassified to these expense lines to conform with the presentation of the four quarters in 2006. As discussed in Note 1 (n) of the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K , stock-based compensation in the four quarters in 2006 is presented in conformity with SFAS 123R.

(3) Components of amortization of intangible assets from acquisitions:

Service costs	$ 2,393,425	$ 3,890,299	$ 3,795,373	$ 3,704,501	$ 3,370,673	$ 3,475,158	$ 3,595,177	$ 3,456,162
Sales and marketing	120,833	204,722	448,611	520,834	520,833	667,751	732,473	715,000
General and administrative	568,899	854,630	947,715	979,166	979,167	1,021,282	981,452	950,000
Total	$ 3,083,157	$ 4,949,651	$ 5,191,699	$ 5,204,501	$ 4,870,673	$ 5,164,191	$ 5,309,102	$ 5,121,162

(4) First quarter 2006 includes a $970,000 conversion payment related to the conversion of 80,848 preferred shares of the Company's 4.75% convertible exchangeable preferred stock. Fourth quarter of 2006 includes a $5.8 million discount on preferred stock redemption related to the redemption of 132,379 shares of the Company's 4.75% convertible exchangeable preferred stock.

Liquidity and Capital Resources

On April 5, 2004, we completed our initial public offering of 4.6 million shares of Class B common stock. The proceeds received in the second quarter of fiscal year 2004 from the stock offering, net of cash offering expenses and underwriter discounts, were $27.2 million. All of the net proceeds have been used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations, working capital and other general corporate purposes. On April 5, 2004, all of our outstanding shares of Series A redeemable convertible preferred stock, with a value of $21.8 million, were automatically converted into Class B common stock in connection with the closing of our initial public offering and are now included as components of stockholders equity.

In February 2005, we closed a follow-on offering of 9,200,000 shares of Class B common stock at a public offering price of $20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of $250 per share and with a liquidation preference of $250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of $12.2 million, were approximately $174.1 million and $55.3 million, respectively, for an aggregate amount of $229.4 million. Concurrent with the close of our offerings, we completed the acquisition of certain assets of Name Development, a corporation operating in the direct navigation market, for purchase consideration of $164.4 million, including approximately $155.6 million in cash and acquisition costs and approximately 419,659 shares of our Class B common stock valued (for accounting purposes) at an aggregate amount of approximately $8.8 million. All of the net proceeds have been used to fund the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006 and for working capital and other general corporate purposes.

As of December 31, 2005 and 2006, we had cash and cash equivalents of $63.1 million and $46.1 million, respectively. As of December 31, 2006, we had contractual obligations of $5.9 million of which $3.9 million is for rent under our facility leases.

Upon adoption of SFAS 123R on January 1, 2006, we are reporting the excess tax benefit from stock options as financing cash inflows rather than as an operating cash inflows as prescribed under the prior accounting rules in accordance with the modified prospective transition method of SFAS 123R. The tax benefit from stock options for the prior year has not been restated to conform to the current presentation.

Cash provided by operating activities primarily consists of net income (loss) adjusted for certain non-cash items such as depreciation and amortization, income and excess tax benefit from stock options, stock-based compensation facility relocation amounts, deferred income taxes, cumulative effect of a change in accounting principle and changes in working capital. Cash provided by operating activities for the year ended December 31, 2006 of approximately $30.8 million consisted primarily of a net loss of $444,000 adjusted for non-cash items of $35.4 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes, cumulative effect of a change in accounting principle and excess income tax benefit related to stock options and approximately $4.1 million used in working capital and other activities. Cash provided by operating activities for the year ended December 31, 2005 of approximately $17.5 million consisted primarily of net income of $3.9 million adjusted for non-cash items of $26.8 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes and income tax benefit related to stock options and approximately $13.3 million used in working capital, other activities and for increases in restricted cash for credit card authorization agencies. Cash provided by operating activities for the year ended December 31, 2004 of approximately $3.7 million consisted primarily of a net loss of $733,000 adjusted for non-cash items of $6.5 million, including depreciation and amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes, and income tax benefit related to stock options and approximately $2.0 million used by working capital and other activities.

With respect to a significant portion of our pay-per-click advertising services, we receive payment prior to our delivery of related click-throughs. Our corresponding payments to the distribution partners who provide placement for the listings are generally made only after our delivery of a click-through. In most cases, the amount payable to the distribution partner will be calculated at the end of a calendar month, with a payment period following the delivery of the click-throughs. This payment structure results in a lag period between the earlier receipt of the cash from the merchant advertisers and the later payment to the distribution partners. These services constituted the majority of revenue in 2004, 2005 and 2006. In certain cases, payments to distribution partners are paid in advance or are fixed in advance based on a guaranteed minimum amount of usage delivered.

Nearly all of the feed management services and advertising services provider arrangements are billed on a monthly basis following the month of our click-through delivery. This payment structure results in our advancement of monies to the distribution partners who have provided the corresponding placements of the listings. For these services, merchant advertiser s payments are generally received one to three weeks following payment to the distribution partners. We expect that in the future periods, if the feed management services account for a greater percentage of our operating activity, working capital requirements will increase as a result.

Cash used in investing activities for the year ended December 31, 2006 of approximately $23.5 million was primarily attributable to the payments for the AreaConnect and Open List asset acquisitions totaling approximately $18.5 million, purchases for Internet domain names or Web sites of approximately $1.1 million and net purchases for property and equipment of $5.9 million, offset by proceeds from the sales of intangible assets of approximately $1.8 million, and proceeds, net of legal fees, from the settlement of certain intangible asset indemnification obligations in connection with our 2005 acquisitions of approximately $347,000. Cash used in investing activities for the year ended December 31, 2005 of approximately $208.9 million was primarily attributable to the payment of the Name Development asset acquisition for approximately $155.5 million, the payment of the Pike Street asset acquisition for approximately $12.8 million, the payment of the IndustryBrains acquisition for approximately $16.1 million which is net of cash acquired of $1.1 million, the 2004 Enhance Interactive earn-out consideration payment of $5.7 million, purchases for Internet domain names or Web sites of approximately $12.6 million, payment for a prepaid license of $4.5 million and net purchases for property and equipment of $2.5 million offset by proceeds of $942,000 from the sales of intangible assets. Cash used in investing activities for the 2004 period of approximately $12.5 million was primarily attributable to the payment of the goClick acquisition for approximately $7.5 million which is net of cash acquired, the 2003 Enhance earn-out consideration payment of approximately $3.2 million, purchases of property and equipment of $1.0 million, and purchases of Internet domain names or Web sites of approximately $697,000.

As a result of our acquisitions, we increased our property and equipment purchases for items such as network equipment and software, furniture, software and equipment for our personnel, and systems used to sell to and serve merchant advertisers. As our operations increase, we expect property and equipment purchases will increase as we continue to invest in equipment and software for our systems and personnel. Additionally, we have expended amounts for product development initiatives as well as amounts recorded as part of property and equipment for internally developed software. We expect our expenditures for product development initiatives and internally developed software will increase in absolute dollars as our development activities accelerate and we increase the number of personnel and consultants to enhance our service offerings.

Cash used in financing activities for the year ended December 31, 2006 of approximately $24.3 million was primarily attributable to the repurchase of an aggregate of 132,379 shares of preferred stock outstanding at a price of $195.00 per share (plus commissions) totaling approximately $26.0 million, preferred dividend payments of $2.9 million which included the one-time payment of $970,000 associated with the voluntary conversion of 80,848 shares of our preferred stock into 824,980 shares of our Class B common stock offset by net proceeds of approximately $2.2 million from the sale of stock through employee stock options and employee stock purchases and $2.5 million of excess tax benefit related to stock options. Cash provided by financing activities for the year ended December 31, 2005 of approximately $229.6 million was primarily attributable to net proceeds from the follow-on offering in February 2005 of approximately $229.4 million, net proceeds of approximately

$2.2 million from the sale of stock through employee stock options and employee stock purchase plan offset by preferred dividend payments of $2.1 million. Cash provided by financing activities for the year ended December 31, 2004 of approximately $27.7 million was primarily attributable to net proceeds from our initial public offering.

For purposes of the calculations of the contingent earnings and revenue-based payment obligations for Enhance Interactive and TrafficLeader in 2004, we allocated revenue based on the source of revenue. We attributed revenue from products and services originating with Enhance Interactive to Enhance Interactive, and likewise we attributed revenue from products and services originating with TrafficLeader to TrafficLeader. Consistent with that approach, we allocated revenues based on origination of merchant advertiser and distribution partner relationships and agreements.

For calendar year 2004, the total aggregate Enhance Interactive contingent, earnings-based payment obligation was $6.2 million. This payment obligation includes the earn-out consideration of approximately $5.7 million and the retention-related consideration of approximately $499,000 for calendar year 2004. The amounts for the calendar year 2004 were paid in March 2005. Subsequent to December 31, 2004, no further obligation exists related to the Enhance Interactive earn-out and retention-related consideration.

The following table summarizes our contractual obligations as of December 31, 2006, and the effect these obligations are expected to have on our liquidity and cash flows in future periods.

	Total	Less than 1 year	1-3 years	4-5 years
Contractual Obligations:				
Operating leases (3)	$ 3,895,991	$ 1,390,693	$ 2,336,004	$ 169,294
Capital leases	58,929	20,539	38,390	
Other contractual obligations	1,903,841	1,362,599	541,242	
Total contractual obligations (1), (2)	$ 5,858,761	$ 2,773,831	$ 2,915,636	$ 169,294

(1) In February 2005 we entered into (i) a new master agreement with Yahoo! Search Marketing (formerly, Overture) with respect to our direct navigation business, and (ii) a license agreement with Yahoo! Search Marketing (formerly, Overture) with respect to certain of Overture s patents, including but not limited to U.S. Patent No. 6,269,361, pursuant to which we paid $4.5 million (and an additional $674,000 in certain circumstances), in an upfront payment and a contingent royalty based on a discounted rate of 3% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016. The upfront license fee has been capitalized and is being amortized ratably over 42 months. The royalty payment is recognized as incurred in service costs. The royalty payments are not included in the above schedule.

(2) Under the terms of the preferred stock offering in February 2005, we have a quarterly dividend payment obligation. Dividends are cumulative and payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005 at an annual rate of $11.875 per preferred share. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.

(3) During 2007, the Company incurred other contractual obligations related to minimum contractual payments due to distribution partners totaling approximately $320,000. These commitments relate to 2007 and are not included in the above table.

During 2005 and 2006, we paid approximately $12.6 million and $1.1 million, respectively, for the purchase of additional Internet domains or Web sites. We expect to continue acquiring Internet domains or Web sites in the normal course of business as we grow our presence in the field of direct navigation.

We anticipate that we will need to invest working capital towards the development and expansion of our overall operations. We may also make a significant number of acquisitions, which could result in the reduction of our cash balances or the incurrence of debt. We have allocated a portion of net proceeds from our offerings to fund acquisitions. Furthermore, we expect that capital expenditures may increase in future periods, particularly if our operating activity increases.

We will have an annual dividend payment obligation under the terms of the preferred stock of $82,000 based upon approximately 6,933 convertible preferred shares outstanding as of March 16, 2007. Dividends are cumulative and payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005 at an annual rate of $11.875 per preferred share.

Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year before the dividend is declared by the board of directors. If we were to exchange the preferred stock for debentures, we would assume the principal and interest payment obligations under the terms of the debentures. Our ability to pay dividends under the preferred stock or to make payments of principal and interest under the debentures in the future will depend on our financial results, liquidity and financial condition.

In November 2006, our Board of Directors authorized a share repurchase program to repurchase up to 3 million shares of our Class B common stock as well as the initiation of a quarterly cash dividend for the holders of the Class A common stock and Class B common stock. Under the share repurchase program, repurchases may take place in the open market and in privately negotiated transactions and at times and in such amounts as we deem appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice.

The quarterly cash dividend was initiated at $0.02 per share of Class A common stock and Class B common stock. Quarterly dividends were paid on February 15, 2007 to Class A and Class B common stockholders of record as of the close of business on February 2, 2007. The aggregate quarterly dividend paid was approximately $832,000. Although we expect that the annual cash dividend, subject to capital availability, will be $0.08 per common share or approximately $3.3 million for the foreseeable future, there can be no assurance that we will continue to pay dividends at such a rate or at all.

On July 7, 2005, a Registration Statement on Form S-3 (File No. 333-125372) relating to the resale of 1,382,093 shares of our Class B common stock by certain selling stockholders with S-3 or piggyback registration rights granted principally in connection with our prior acquisitions was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective until April 26, 2006. We will not receive any proceeds in connection with these sales by selling stockholders.

On September 29, 2005, a Registration Statement on Form S-3 (File No. 333-128317) relating to the resale of 964,955 shares of our Class B common stock by certain selling stockholders with S-3 registration rights granted in connection with the IndustryBrains acquisition was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective for a period of one year from the date the Registration Statement became effective (plus the period of time, if any, during which sales may be suspended while the suspension right is in effect). We will not receive any proceeds in connection with these sales by selling stockholders.

On June 21, 2006, a Registration Statement on Form S-3 (File No. 333-134851) relating to the resale of 662,717 shares of our Class B common stock by certain selling stockholders with S-3 registration rights granted in connection with the AreaConnect and Open List asset acquisitions was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective until May 26, 2007 (plus the period of time, if any, during which sales may be suspended while the suspension right is in effect). We will not receive any proceeds in connection with these sales by selling stockholders.

Based on our operating plans we believe that the proceeds from our follow-on public offering, together with existing resources and cash flow provided by ongoing operations, will be sufficient to fund our operations for at least twelve months. Additional equity and debt financing may be needed to support our acquisition strategy, our long-term obligations and our Company s needs. If additional financing is necessary, it may not be available; and if it is available, it may not be possible for us to obtain financing on satisfactory terms. Failure to generate sufficient revenue or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives.

Critical Accounting Policies

The policies below are critical to our business operations and the understanding of our results of operations. In the ordinary course of business, we make a number of estimates and assumptions relating to the reporting of our results.

Our consolidated financial statements have been prepared using accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and the related disclosures of contingent assets and liabilities. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies relate to the following matters and are described below:

- Revenue;
- Goodwill and intangible assets;
- Stock-based compensation; and
- Allowance for doubtful accounts, merchant advertiser and incentive program credits.

Revenue

We currently generate revenue through our operating businesses by delivering performance-based and search marketing services to merchant advertisers and advertising service providers. The primary revenue driver has been performance-based advertising, which includes pay-per-click listings, cost-per-action services and feed management services. For pay-per-click listing and feed management services, revenue is recognized upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers listing which occurs when an online user clicks on any of their advertisements after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. For cost-per-action services, revenue is recognized when the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to an advertiser Web site and completes the specified action. In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on the related receivables may vary from reported information based upon third party refinement of the estimated and reported amounts owing that occurs subsequent to period ends.

We have entered into agreements with various distribution partners in order to expand our distribution network, which includes search engines, directories, product shopping engines, certain third-party Web sites and our portfolio of owned Web sites, on which we include our merchant advertisers listings. We generally pay distribution partners based on a specified percentage of revenue or a fixed amount per click-through on these listings. We act as the primary obligor in these transactions, and we are responsible for providing customer and administrative services to the merchant advertiser. In accordance with Emerging Issues Task Force Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the revenue derived from merchant advertisers who receive paid introductions through us as supplied by distribution partners is reported gross based upon the amounts received from the merchant advertiser. We also recognize revenue for certain agency contracts with merchant advertisers under the net revenue recognition method. Under these specific agreements, we purchase listings on behalf of merchant advertisers from search engines and directories. We are paid an agency fee based on the total amount of the purchase made on behalf of these merchant advertisers. Under these agreements, our merchant advertisers are primarily responsible for choosing the publisher and determining pricing, and the Company, in certain instances, is only financially liable to the publisher for the amount collected from our merchant advertisers. This creates a sequential liability for media purchases made on behalf of merchant advertisers. In certain instances, the web publishers engage the merchant advertisers directly and we are paid an agency fee based on the total amount of the purchase made by the merchant advertiser.

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of identifiable assets acquired and liabilities assumed in business combinations accounted for under the purchase method.

We apply the provisions of the Financial Accounting Standards Board s (FASB) Statements of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS 142). Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Asset (SFAS 144).

Goodwill is tested annually for impairment and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset s fair value. To date, no impairment charge has been taken for the goodwill related to our acquisitions. If the fair value is lower than the carrying value, a material impairment charge may be reported in our financial results. We exercise judgment in the assessment of the related useful lives of intangible assets, the fair values and the recoverability. In certain instances, the fair value is determined in part based on cash flow forecasts and discount rate estimates. We review our long-lived assets for impairment in accordance with SFAS 144 whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If such asset group is considered to be impaired, the impairment is to be recognized by the amount by which the carrying amount of the assets exceeds fair value. Assets to be disposed of are separately presented on the balance sheet and reported at the lower of their carrying amount or fair value less costs to sell, and are no longer depreciated.

No impairment of significance of our intangible assets has been indicated to date. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased.

As a result of the significance of the goodwill and intangible asset carrying values, any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

Stock-Based Compensation

On January 1, 2006, we adopted SFAS 123R using the modified prospective transition method and therefore have not restated prior periods results. SFAS 123R requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock issuances based on estimated fair values. Under the fair value recognition provisions of SFAS 123R, we recognize stock-based compensation net of an estimated forfeiture rate and therefore only recognize compensation cost for those shares expected to vest over the service period of the award. Prior to SFAS 123R, we accounted for share-based payments under APB 25 and accordingly, generally recognized compensation expense related to restricted stock awards and stock options with intrinsic value and accounted for forfeitures as they occurred.

Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with FAS 123R, the assumptions used in calculating fair value of stock-based awards and the Black-Scholes option pricing model are highly subjective, and other reasonable assumptions could provide differing results. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience of our stock-based awards that are granted, exercised and cancelled. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 6 (d) Stock Option Plan in the consolidated financial statements for additional information.

Allowance for Doubtful Accounts and Merchant Advertiser and Incentive Program Credits

Accounts receivable balances are presented net of allowance for doubtful accounts and merchant advertiser credits. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our accounts receivable. We determine our allowance based on analysis of historical bad debts, advertiser concentrations, advertiser creditworthiness and current economic trends. We review the allowance for collectibility on a quarterly basis. Account balances are written off against the allowance after all reasonable means of collection have been exhausted and the potential recovery is considered remote. If the financial condition of our advertisers were to deteriorate, resulting in an impairment of their ability to make payments, or if we underestimated the allowances required, additional allowances may be required which would result in increased general and administrative expenses in the period such determination was made.

We determine our allowance for merchant advertiser credits and adjustments based upon our analysis of historical credits. Under the merchant advertiser incentive program, we grant merchant advertisers credits depending upon the individual amounts of prepayments made. The incentive program allowance is determined based on the historical rate of incentives earned and used by merchant advertisers compared to the related revenues recognized by us. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments and estimates.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* This pronouncement prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company s tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company believes the adoption of FIN 48 will not have a material impact on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which

Table of Contents

provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 are effective for the Company for the fiscal year ended December 31, 2006. The adoption of SAB 108 did not have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements,* which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the effect that SFAS 157 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the Company on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 159 on its financial position, cash flows, and results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is limited to interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term, money market funds. We place our investments with high-quality financial institutions and limit the amount of credit exposure to any one financial institution. During the years ended December 31, 2005 and December 31, 2006, the effects of changes in interest rates on the fair market value of our investments and our earnings were not material. Further, we believe that the impact on the fair market value of our investments and our earnings from a hypothetical 10% change in interest rates would not be significant. We do not have any material foreign currency or other derivative financial instruments.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

INDEX TO FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Marchex, Inc.:

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

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

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

As discussed in Note 1(n), effective January 1, 2006, the beginning of the Company s fiscal year ended December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Marchex, Inc. s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2007 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 15, 2007

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Marchex, Inc.:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, appearing under Item 9A, that Marchex, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Marchex, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Marchex, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Marchex, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Marchex, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 15, 2007 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 15, 2007

Table of Contents

MARCHEX, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

	As of December 31, 2005	2006
Assets		
Current assets:		
Cash and cash equivalents	$ 63,090,941	$ 46,105,827
Accounts receivable, net	14,401,814	22,035,343
Prepaid expenses and other current assets	1,818,211	2,221,550
Refundable taxes	3,835,542	1,837,166
Deferred tax assets	428,855	670,624
Total current assets	83,575,363	72,870,510
Property and equipment, net	3,402,262	7,280,075
Deferred tax assets		2,444,782
Intangible and other assets, net	15,447,504	13,318,801
Goodwill	180,637,076	200,738,098
Intangible assets from acquisitions, net	51,346,944	36,735,570
Total assets	$ 334,409,149	$ 333,387,836
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 9,258,423	$ 10,739,231
Accrued expenses and other current liabilities	1,755,970	2,913,152
Deferred revenue	2,291,374	2,430,644
Total current liabilities	13,305,767	16,083,027
Deferred tax liabilities	397,481	
Other non-current liabilities	92,309	91,907
Total liabilities	13,795,557	16,174,934
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock, $.01 par value: 1,000,000 shares authorized; 225,485 and 9,758 shares issued and outstanding at December 31, 2005 and 2006, respectively; Aggregate liquidation preference of $56,720,830 and $2,453,991 at December 31, 2005 and 2006, respectively	54,121,678	2,342,884
Common stock, $.01 par value. Authorized 137,500,000 shares;		
Class A: 12,500,000 shares authorized; 11,928,216 and 11,665,716 shares issued and outstanding, respectively, at December 31, 2005; and 11,921,716 and 11,659,216 shares issued and outstanding, respectively, at December 31, 2006	119,282	119,217
Class B: 125,000,000 shares authorized; 25,617,249 and 25,483,939 shares issued and outstanding, respectively, at December 31, 2005, including 293,171 of restricted stock at December 31, 2005; and 27,798,529 and 27,636,055 shares issued and outstanding, respectively, at December 31, 2006, including 316,645 of restricted stock at December 31, 2006.	254,839	276,361
Additional paid-in capital	271,949,963	320,607,113
Deferred stock-based compensation	(3,042,016)	
Accumulated deficit	(2,790,154)	(6,132,673)
Total stockholders equity	320,613,592	317,212,902

Total liabilities and stockholders equity	$ 334,409,149	$ 333,387,836

See accompanying notes to consolidated financial statements.

Table of Contents

MARCHEX, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

	Years ended December 31, 2004	2005	2006
Revenue	$ 43,804,272	$ 94,995,847	$ 127,759,475
Expenses:			
Service costs (1), (3)	27,460,738	48,901,826	60,433,611
Sales and marketing (1), (3)	4,569,777	11,127,037	23,050,654
Product development (1), (3)	2,351,313	4,494,558	10,094,967
General and administrative (1), (3)	4,775,647	7,194,905	13,533,215
Amortization of intangible assets from acquisitions (4)	4,965,503	18,429,008	20,465,128
Acquisition-related retention consideration (2)	499,080		
Facility relocation	199,960		
Total operating expenses	44,822,018	90,147,334	127,577,575
Gain (loss) on sales and disposals of intangible assets, net		997	369,960
Income (loss) from operations	(1,017,746)	4,849,510	551,860
Other income (expense):			
Interest income	265,354	1,982,222	3,161,019
Interest expense	(5,654)	(7,463)	(8,292)
Adjustment to fair value of redemption obligation	55,250		
Other	3,644	4,000	(9,364)
Total other income	318,594	1,978,759	3,143,363
Income (loss) before provision for income taxes	(699,152)	6,828,269	3,695,223
Income tax expense	33,941	2,920,463	4,290,201
Income (loss) before cumulative effect of change in accounting principle	(733,093)	3,907,806	(594,978)
Cumulative effect of a change in accounting principle, net of tax			151,341
Net income (loss)	(733,093)	3,907,806	(443,637)
Convertible preferred stock dividends, conversion payment, and discount on preferred stock redemption, net		2,405,780	(3,197,341)
Accretion to redemption value of redeemable convertible preferred stock	420,430		
Net income (loss) applicable to common stockholders	$ (1,153,523)	$ 1,502,026	$ 2,753,704
Basic net income (loss) per share applicable to common stockholders	$ (0.05)	$ 0.04	$ 0.07
Diluted net income (loss) per share applicable to common stockholders	$ (0.05)	$ 0.04	$ (0.04)
Shares used to calculate basic net income (loss) per share applicable to common stockholders	22,087,503	34,564,790	38,261,884
Shares used to calculate diluted net income (loss) per share applicable to common stockholders	22,087,503	36,907,633	39,500,123

(1) Excludes acquisition-related retention consideration and amortization of intangible assets from acquisitions.

(2) Components of acquisition-related retention consideration:

Service costs	$ 116,585	$	$
Sales and marketing	204,528		
Product development	135,947		
General and administrative	42,020		
Total	$ 499,080	$	$

(3) Includes stock-based compensation as follows: