MARCHEX INC
Form 10KSB
March 31, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-KSB

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

For the fiscal year ended December 31, 2005

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

413 Pine Street, Suite 500, Seattle, Washington 98101

(Address of principal executive offices)

Registrant s telephone number: (206) 331-3300

Securities registered under Section 12(b) of the Act:

None

Securities registered under Section 12(g) of the Act:

Class B Common Stock, $0.01 par value per share

4.75% Convertible Exchangeable Preferred Stock $0.01 par value per share

Check mark whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes ¨ No x

Check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 ¨

Check mark if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. Yes x No ¨

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

Registrant s revenues for its fiscal year ended December 31, 2005 were $94,995,847.

Aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was approximately $461,056,190 as of February 15, 2006 based upon the closing sale price on the Nasdaq National Market reported for such date. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

There were 11,665,716 shares of the registrant s Class A common stock issued and outstanding as of March 28, 2006 and 26,553,294 shares of the registrant s Class B common stock issued and outstanding as of March 28, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates information by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held on May 12, 2006.

Transitional Small Business Disclosure Format (check one): Yes ¨ No x

Table of Contents

TABLE OF CONTENTS

		Page
	Part I	
ITEM 1.	DESCRIPTION OF BUSINESS	1
ITEM 2.	DESCRIPTION OF PROPERTY	17
ITEM 3.	LEGAL PROCEEDINGS	17
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	17
	Part II	
ITEM 5.	MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS	18
ITEM 6.	MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION	20
ITEM 7.	FINANCIAL STATEMENTS	61
ITEM 8.	CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE	96
ITEM 8A.	CONTROLS AND PROCEDURES	96
ITEM 8B.	OTHER INFORMATION	96
	Part III	
ITEM 9.	DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT	97
ITEM 10.	EXECUTIVE COMPENSATION	97
ITEM 11.	SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS	97
ITEM 12.	CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS	97
ITEM 13.	EXHIBITS	97
ITEM 14.	PRINCIPAL ACCOUNTANT FEES AND SERVICES	97
SIGNATURES		
EXHIBIT INDEX		

Table of Contents

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-KSB 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 or Plan of Operation 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 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. DESCRIPTION OF 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 deliver vertical and local online traffic to merchant advertisers and help publishers monetize traffic on their Web site(s). We do this primarily through providing merchants with performance-based advertising and search marketing technology services 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 through providing 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 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, Forbes.com, Travel + Leisure, the Ziff Davis Media Web sites, and others. Our proprietary network is comprised of more than 200,000 Web sites.

Table of Contents

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 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 services for merchants:

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.

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 as site-specific contextual advertising. We believe this site-specific approach to contextual advertising allows publishers 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. At present, 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 and other Web sites. We also generate revenue from cost-per-action services, which occur when the online user is redirected from the Company Web sites 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. We create, distribute and fulfill local merchant advertisements through our network of distribution, which includes many of the leading search engines, such as Yahoo! and Google, and our proprietary vertical and local Web sites.

We believe we are among the leaders in the direct navigation market as we own a proprietary base of Web sites. The total number of Web sites in the portfolio is more than 200,000. Our Web sites can be categorized into 15 vertical commerce categories including: Auto, Business & Finance, Directory & Reference, Education,

Table of Contents

Electronics & Technology, Entertainment, Health, Jobs, Other, 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 our inception:

On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary 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.

On July 27, 2005, we acquired IndustryBrains.

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. Businesses of all sizes can benefit from the Internet s potential to efficiently and cost-effectively reach consumers. With the U.S. Census Bureau reporting more than 23 million small businesses alone, 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, J.P. Morgan estimates that the United States Online Ad Market will grow from $13.4 billion in 2005 to $26.4 billion in 2008. 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. J.P. Morgan estimates that paid search in the United States will grow 109% from $6.4 billion in 2005 to $13.4 billion in 2009. 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 PricewaterhouseCoopers, 40% of Internet advertising in the second quarter of 2004 was performance-based, as opposed to 31% in the second quarter of 2003. 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, J.P Morgan estimates that the average price-per-click in the United States will increase from $0.43 to in 2005 to $0.49 in 2009.

Consumers Increasing Receptiveness to Performance-Based Advertising. Due to the relevancy and appropriate placement of advertisements, J.P. Morgan estimates that the rate at which consumers click through paid search advertisements will grow from 23% in 2005 to 26% in 2009.

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.

J.P. Morgan estimates that the United States paid search market will reach $6.4 billion in revenue in 2005, 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:

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. For example, the services we have developed include:

- a search engine inclusion and optimization platform for merchant advertisers who want the greatest opportunity for proper indexing, listing and inclusion of their product and services in the editorial results of algorithmic search engines;
- an advertising campaign management platform for merchant advertisers who want to 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
- an outsourced search marketing services platform for large aggregators of advertisers, such as yellow page companies, who want an integrated platform to market performance-based advertising and search marketing services directly to their customers.

4

Table of Contents

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.

Extend 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 enhancing the utility of the Web sites, broadening our geographic presence and making selective purchases of complementary Web sites.

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. 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. 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 our Web sites to a merchant advertiser Web site and completes the specified action.
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 period ended December 31, 2005, performance-based advertising services comprised more than 94% of our total revenue while search marketing services and outsourced search marketing platform services accounted for less than 6% of 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.

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

6

Table of Contents

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:

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.

Table of Contents

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 our Web sites 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. This process has the dual benefit of: (1) enhancing the user experience by placing relevant targeted listings at the portion of a search page dedicated to sponsored listings; and (2) connecting merchant advertisers with targeted customer leads.

When merchant advertisers submit advertisement listings to our service, we review them for relevance and for conformity with our editorial guidelines. We may also 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.

Merchant advertisers find us directly through our Web site 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.

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

Table of Contents

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 revenue 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 it can market to its 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.

Table of Contents

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 and selected Web sites. With the completion of the recent Name Development asset acquisition, we acquired a proprietary source of direct navigation traffic.

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.com (formerly Ask Jeeves)	CNet s MySimon	Bank Rate
Google	Google s Froogle.com	BusinessWeek.com
LookSmart	MSN Shopping	Fodors
Microsoft	NexTag	Forbes.com
Yahoo!	PriceGrabber.com	Investors.com (Investors Business Daily)
	Shopping.com	Motley Fool
	Shopzilla	The Ziff Davis Media Web sites
	Yahoo!Shopping	Travel + Leisure
		USAToday

Yahoo!, primarily through its subsidiaries, such as Overture and Yahoo!Shopping, is our largest distribution partner, accounting for approximately 11% of our total revenue for the year ended December 31, 2005. Over the past year, we have enhanced and grown this relationship with additional agreements with Yahoo! and its subsidiaries. Additionally, we have enhanced existing relationships with various other partners, including Google, and created several new relationships, including Microsoft, Ask.com (formerly Ask Jeeves), Shopzilla, BusinessWeek.com, Forbes.com, Investors.com and Fodors.com. We intend to continue enhancing our existing partner relationships and create new ones, where appropriate.

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:

- 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 27 million unique visitors in the month of December 2005. 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 may include geographically-targeted elements. The total number of Web sites we own is more than 200,000. These vertical commerce categories include: Auto, Business & Finance, Directory & Reference, Education, Electronics & Technology, Entertainment, Health, Jobs, Other, 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.

Table of Contents

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.

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 MotorScooter.com PickUp.com
Business & Finance	AnnualReport.com Corporations.com Debts.com LoanConsolidation.com
Directory & Reference	MovieDirectory.com PhoneNumbers.com SearchLocal.com Yellow.com
Education	CollegeGuide.com GED.com Instruct.com Trigonometry.com
Electronics & Technology	3G.com PBX.com TextMessaging.com VideoCamera(s).com
Entertainment	Cuisine.com Invitation.com MovieDownload.com Salsa.com
Health	DrugTreatment.com

	EyeSurgeons.com
	HearingLoss.com
	Podiatrist.com
Jobs	BayAreaJobs.com
	CareerInfo.com
	HealthJobs.com
	MiamiJobs.com
Other	Certificate.com
	Decals.com
	Dolphins.com
	Tornado.com
Personals	MatchMaking.com
	Matrimony.com
	WeddingCeremony.com
	WeddingReceptions.com

11

Table of Contents

Vertical Commerce Category	Web Site Examples
Professional Services	ChicagoDoctors.com ManhattanSurgeon.com PaloAltoDoctors.com SeattleInsurance.com
Real Estate & Home	HomeLenders.com LawnFurniture.com Ovens.com Remodeling.com
Travel	Beijing.com Destination.com IslandResorts.com TourGuide.com
ZIP Codes	10013.com 60614.com 90210.com 94123.com

Sales, Marketing & Business Development

As of December 31, 2005, we had 49 full-time employee equivalents in our sales department, 11 full-time employee equivalents in our business development department and 10 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

Table of Contents

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, Intel, Microsoft, Sun Microsystems and Veritas. We also utilize public domain software such as Apache, Oracle, 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 all relevant companies in the 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 all 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

Table of Contents

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. Although overall Internet advertising expenditures have increased in the last few years, the advertising industry has suffered as many online businesses have ceased operations and many traditional businesses have scaled back their advertising budgets. 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 AOL, Google, Microsoft and Yahoo!, through its subsidiaries, 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 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 and Pike Street 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.

Table of Contents

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 two 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 and PCT patent applications filed on September 23, 2004, and which are currently pending. These patent applications describe 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 and PCT patent applications filed on November 19, 2004, and which are 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.

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 been issued registered trademarks in the United States covering certain goods and services for Marchex, Direct Search Inclusion, goClick.com, Sitewise and TrafficLeader. We have also applied for registered trademark status for Enhance Interactive in the United States. In addition, we have been issued registered trademarks for Marchex in Australia, Benelux, Canada, China, France, Germany, Hong Kong, Japan, Italy, Spain, Sweden, Republic of Korea, Russian Federation, Taiwan and the United Kingdom. We have also applied for registered trademark status for 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 in many cases. Such uncertainty arises under existing laws regulating matters, including user privacy, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, content regulation, quality of products and services, and intellectual property ownership and infringement.

Table of Contents

To resolve some of the current legal uncertainties, we expect new laws and regulations to be adopted that will be directly applicable to our activities. Any existing or new legislation applicable to us could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations, and could dampen the growth in use of the Internet in general.

Several new federal laws that could have an impact on our business have already been adopted. The Digital Millennium Copyright Act is intended to reduce the liability of online service providers for listing or linking to third party Web sites that include materials that infringe copyrights or rights of others. The Children s Online Protection Act and the Children s Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children from Sexual Predators Act requires online services providers to report evidence of violations of federal child pornography laws under certain circumstances. The foregoing legislation may impose significant additional costs on our business or subject us to additional liabilities, if we were not to comply fully with their terms, whether intentionally or not. If we did not meet the safe harbor requirements of the Digital Millennium Copyright Act, we could be exposed to copyright actions, which could be costly and time-consuming. The Children s Online Protection Act and the Children s Online Privacy Protection Act impose fines and penalties to persons and operators that are not fully compliant with their requirements. The federal government could impose penalties on those parties that do not meet the full compliance practices of the Protection of Children from Sexual Predators Act. We intend to fully comply with the laws and regulations that govern our industry, and we employ internal resources and incur outside professional fees to establish, review and maintain policies and procedures to reduce the risk of noncompliance.

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 holding Internet domain names.

We post our privacy policy and practices concerning the use and disclosure of any user data on our relevant 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 proceedings by governmental or regulatory bodies that could potentially harm our businesses, results of operations and financial condition. In this regard, there are a large number of legislative proposals before the U.S. Congress and various state legislative bodies regarding privacy issues related to our business. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could harm our business through a decrease in user registrations and revenue. These decreases could be caused by, among other possible provisions, the required use of disclaimers or other requirements before users can utilize our services.

Employees

As of December 31, 2005, we employed a total of 260 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-KSB, quarterly reports on Form 10-QSB, 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.

Table of Contents

ITEM 2. DESCRIPTION OF PROPERTY.

Our headquarters are located in Seattle, Washington and consist of approximately 11,400 square feet of leased office space (increasing to 26,788 square feet over the lease term). The lease term for this office space expires in December 2009. We also have facilities in Orem, Utah where we lease approximately 10,665 square feet of office space under a lease which expires in August 2008 and in Eugene, Oregon where we lease approximately 6,725 square feet of office space under a lease which expires in October 2006. We also lease additional office space in Seattle, Washington; Las Vegas, Nevada; and New York, New York. These leases represent an aggregate of approximately 22,653 square feet of additional office space with lease terms expiring between June 2006 and November 2010. Our information technology systems are hosted and maintained in third party facilities under collocation services agreements. See 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.

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 2005 to a vote of security holders, through solicitation or proxies or otherwise.

Table of Contents

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

Market Information

Our Class B common stock has been traded on 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 National Market:

	High	Low
Year ended December 31, 2004		
First Quarter (Beginning March 31, 2004)	$ 8.88	$ 8.88
Second Quarter	$ 13.28	$ 9.50
Third Quarter	$ 13.35	$ 8.56
Fourth Quarter	$ 21.00	$ 12.40
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

Holders

As of December 31, 2005, there were 37,149,655 shares of common stock outstanding that were held by 392 stockholders of record. Of these shares:

11,665,716 shares were issued as Class A common stock, and as of this date were held by 5 stockholders of record; and

25,483,939 shares were issued as Class B common stock, and as of this date were held by 387 stockholders of record.

Dividends

In February 2005, the Company closed its offering of 230,000 shares of 4.75% convertible exchangeable preferred stock with a liquidation preference of $250 per share. This amount includes the exercise by the Company s underwriters of their over-allotment option to purchase 30,000 additional shares of preferred stock.

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.

We have never declared or paid any cash dividends on shares of our common stock. Except for dividends payable on the preferred stock, we currently intend to retain our earnings for future growth and do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. Any future determination to pay dividends on such shares will be at the discretion of our board of directors and will depend on a number of factors, such as our results of operations, capital requirements, financial conditions, future prospects and other factors that the board of directors deems relevant.

Table of Contents

Recent Sales of Unregistered Securities

We issued the following securities, none of which have been registered under the Securities Act of 1933, as amended (the Act) during the fourth quarter of 2005:

Certain warrants issued to the underwriters or their designees as compensation in connection with our initial public offering in April of 2004 were exercised for shares of stock (i) via cashless exercise resulting in the issuance of an aggregate of 6,543 shares of our Class B common stock and (ii) by cash payment of the exercise price of $8.45 per share resulting in the issuance of an aggregate of 8,000 shares of our Class B common stock. No underwriters were involved in these warrant exercises. Such sales and issuances of stock were made in reliance upon an exemption from the registration provisions of the Act set forth in Section 4(2) and Rule 506 of Regulation D thereof relative to the sale by an issuer not involving a public offering or the rules and regulations thereunder.

Issuer Purchases of Equity Securities

We did not repurchase any of our outstanding shares of Class B common stock during the fourth quarter of 2005.

Table of Contents

ITEM 6. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

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-KSB. This discussion contains forward-looking statements. Please see Forward-Looking Statements and 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:

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.

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 as site-specific contextual advertising. We believe this site-specific approach to contextual advertising allows publishers 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 and other Web sites. We also generate revenue from cost-per-action services, which occur when the online user is redirected from the Company web sites 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

20

Table of Contents

outsourced platforms are provided to super-aggregator partners and publishers allowing the partners and publishers to sell under their brand.

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.

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 and 2005 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 estimated acquisition costs; plus

419,659 shares of Class B common stock.

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

Table of Contents

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 estimated 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.

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

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.

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 estimated acquisition costs; plus
- 788,046 shares of Class B common stock; plus
- 176,909 shares of restricted Class B common stock issued 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.

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 and 2005.

Table of Contents

Revenue

We currently generate revenue through our suite of services, including our pay-per-click targeting, feed management, bid management, contextual targeting 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 94% 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 6% 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 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.

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, Internet domains or 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 the Company Web sites to a merchant advertiser Web site and completes the specified action.

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 or inclusion fees as part of our services.

Table of Contents

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 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 indexes 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;

Table of Contents

- license fees;
- credit card processing fees;
- network operations;
- serving our search results;
- maintaining our Web sites;
- domain name registration renewal fees;
- network fees;
- fees paid to outside service providers;
- delivering customer service;
- depreciation of our Web site and network equipment;
- 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 consists of user acquisition costs that relate primarily to payments to our 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 sites and indexes. The primary economic structure of our 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 we may use to a lesser degree 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.

Our method of expensing user acquisition costs is based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed at 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 generally expensed 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; and

- cost of systems used to sell to and serve merchant advertisers.

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; and
- costs incurred in developing features and functionality of the services we offer.

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; and
- other general corporate expenses.

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

Stock-based compensation consists of the following components:

- 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.

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

Table of Contents

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.

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, the Company believes it is more likely than not, based on its operating performance and projections of future taxable income, that the Company s net deferred tax assets will be realized. In determining that it was more likely than not that the Company 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 the Company s projections of future taxable income are reduced or if the Company does not perform at the levels it is 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 the Company and its filings. The Company believes 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, we had net operating loss, or NOL, carryforwards of $1.7 million, 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 NOL carryforwards will never be utilized.

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

27

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 estimated to be approximately $174.1 million and $55.3 million, respectively, for an aggregate amount of $229.4 million. Net proceeds have been used to fund the Name Development asset acquisition, the Pike Street Industries asset acquisition, the IndustryBrains acquisition and for working capital and other general corporate purposes. We intend to use the remainder of the net proceeds for working capital and other general corporate purposes, including for future acquisitions.

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, 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

In January 2006, 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, 2006 to the holders of record as of the close of business on February 4, 2006. This quarterly dividend totaled approximately $662,000.

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, approximately 4,515 shares of preferred stock were converted at the option of the holders into approximately 46,071 shares of the Company s Class B common stock at a conversion price of $24.50 per share. In January 2006, approximately 2,500 shares of preferred stock were converted at the option of the holders into approximately 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 approximately 80,848 shares of the Company s preferred stock into approximately 824,978 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 will be reflected as a preferred stock dividend in the Company s financial statements. Through March 16, 2006, approximately 142,137 shares of preferred stock remain outstanding following the conversions.

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 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, 2005. The Debentures, if issued, will mature 25 years after the exchange date.

Comparison of the periods of the year ended December 31, 2004 (2004 period) to the year ended December 31, 2005 (2005 period)

Revenue. Revenue increased 117%, from $43.8 million for the 2004 period to $95.0 million in the same period in 2005. This increase was attributable to a $47.9 million increase in performance-based advertising services. Of this increase approximately 72% related to an increase in the average revenue per merchant advertiser, while approximately 28% related to an increase in the number of merchant advertisers. Approximately 63%, or $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, $26.8 million is derived from more than 40 advertiser and advertising service provider relationships including the previously mentioned advertising services provider relationship and indirectly attributable to the Name Development and Pike Street asset acquisitions, including their portfolios of more than 100,000 Internet domain names. Of the total increase in revenue, $4.9 million was indirectly attributable to the acquisition of IndustryBrains in July 2005 and its merchant advertisers.

We believe the increase in revenue is primarily a result of the growth of our existing distribution partners, 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 and improved operational controls, have contributed to an increase in the average revenue per merchant advertiser. The increase in revenue in the 2005 period is also attributable to the acquisition of goClick in July 2004, which added more than 40 unique distribution partners and more than 5,000 unique merchant advertisers, and the acquisition of IndustryBrains in July 2005 which added more than 100 unique distribution partners and more than 1,000 unique 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 with merchant advertisers, which we believe is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers.

Expenses

Service Costs. Service costs increased 78% from $27.4 million in the 2004 period to $48.9 million in the same period 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 $814,000, 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 and an increase in registration fees and Internet domain amortization of $2.5 million.

Approximately $13.5 million of the total increase in service costs for the 2005 period was attributable to the July 2004 acquisition of goClick, which was included for a partial period in 2004, and the July 2005 acquisition of IndustryBrains, which was not included in the same period in 2004.

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 represented 63% of revenue in the 2004 period as compared to 51% in 2005. The 2005 decrease as a percentage of revenue in service costs as compared to the same period in 2004 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. 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. To the extent that payments to feed management and pay-per-click services distribution partners make up a larger percentage of future operations, 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, since we anticipate expanding our operations.

Sales and Marketing. Sales and marketing expenses increased 127%, from $4.4 million in the 2004 period to $10.0 million in the same period in 2005. As a percentage of revenue, sales and marketing expenses were 10% and 11% for the 2004 and 2005 periods, respectively. The increase in dollars was related primarily to an increase in personnel costs of $1.4 million related primarily 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

Table of Contents

operating costs arising from operations in multiple jurisdictions. We expect that sales and marketing expenses will increase in absolute dollars 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.

Product Development. Product development expenses increased 95%, from $2.3 million in the 2004 period to $4.5 million in the same period in 2005. As a percentage of revenue, product development expenses were 5% for both the 2004 and 2005 periods, 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. 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.

General and Administrative. General and administrative expenses increased 55%, from $4.1 million in the 2004 period to $6.4 million in the same period in 2005. The increase in dollars was primarily due to an increase in personnel costs of $1.3 million, an increase in professional services of $409,000, an increase in facilities related costs of $348,000, and by a net increase in travel, bad debt, and other costs of $55,000. As a percentage of revenue, general and administrative expenses were 9% for the 2004 period and 7% in the same period 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. We expect that our general and administrative expenses will increase in absolute dollars 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.

Acquisition-Related Retention Consideration. Acquisition-related retention consideration was $499,000 for the 2004 period and zero in the same period in 2005. 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 the 2004 period 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 extend through June 30, 2006 and totaled $52,000 as of December 31, 2005. As of December 31, 2005, we estimate the net sublease income to be approximately $20,000 over the remaining life of the lease.

The remaining lease accrual is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

Stock-Based Compensation. The amortization of stock-based compensation increased 121%, from $891,000 in the 2004 period to $2.0 million in the same period in 2005. In the year ended December 31, 2005, the components of stock-based compensation were service costs of $4,500, sales and marketing of $1.1 million, product development of $29,000 and general and administrative of $830,000. Amounts in the 2004 period related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair market value at the date of grant and $407,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader. Amounts in the 2005 period related primarily to the effect of $1.7 million of stock-based compensation related to restricted stock issued to employees for future services in connection with the TrafficLeader and IndustryBrains acquisitions and the Pike Street asset acquisition net of forfeitures.

Table of Contents

Amortization of Intangible Assets From Acquisitions. Intangible amortization expense increased 271%, from $5.0 million in the 2004 period to $18.4 million in the same period 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 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.

Other Income. Other income increased 521%, from $319,000 in the 2004 period to $2.0 million in the same period 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 period as well as an increase in rates realized on invested funds.

Income Taxes. The income tax expense in the 2004 period was $34,000 as compared to $2.9 million in the same period in 2005. The increase in income taxes was primarily the result of pretax income of $6.8 million in the 2005 period compared to a pretax loss of $700,000 in the same period in 2004.

In the 2004 period, 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. The effective rate was 43% in the 2005 period. This differed from the expected rate of 34% due to state income taxes, non-deductible stock compensation and other amounts.

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

Convertible Preferred Stock Dividends. The convertible preferred stock dividends during the 2005 period of $2.4 million 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 $420,000 in the 2004 and zero in the same period in 2005. The accretion to the redemption value recorded during the 2004 period 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. Net income (loss) applicable to common stockholders increased from a net loss of $1.2 million in the 2004 period to a net income of $1.5 million in the 2005 period. 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.

Table of Contents

Quarterly Results of Operations

The following tables set forth our unaudited quarterly results of operations data for the eight most recent quarters and periods ended December 31, 2005, 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, 2004	**June 30, 2004**	**Sept 30, 2004**	**Dec 31, 2004**	**Mar 31, 2005**	**June 30, 2005**	**Sept 30, 2005**	**Dec 31, 2005**
Consolidated Statement of Operations Data:								
Revenue	$ 7,601,911	$ 8,865,178	$ 12,215,835	$ 15,121,348	$ 18,395,983	$ 21,168,022	$ 25,627,677	$ 29,804,165
Expenses:								
Service costs (1)	4,779,575	5,743,815	7,619,496	9,307,052	10,668,907	10,738,628	13,411,378	14,078,413
Sales and marketing (1)	1,009,972	1,030,710	1,156,314	1,217,047	1,324,986	1,543,895	2,759,826	4,390,150
Product development (1)	505,535	528,306	602,478	655,111	774,549	1,290,545	1,164,152	1,236,517
General and administrative (1)	694,748	846,680	1,072,505	1,497,611	1,452,034	1,473,561	1,494,080	1,944,898
Acquisition-related retention consideration (2)	132,936	122,724	119,198	124,222				
Facility relocation	230,459		(30,499)					
Stock-based compensation (3)	360,764	235,234	125,405	169,117	146,538	497,169	557,958	770,142
Amortization of intangible assets from acquisitions (4)	1,034,868	1,034,643	1,404,464	1,491,527	3,083,157	4,949,651	5,191,699	5,204,501
Total operating expenses	8,748,857	9,542,112	12,069,361	14,461,687	17,450,171	20,493,449	24,579,093	27,624,621
Gain on sales of intangible assets, net								997
Income (loss) from operations	(1,146,946)	(676,934)	146,474	659,661	945,812	674,573	1,048,584	2,180,541
Other income (expense):								
Interest income	11,016	70,329	82,462	101,546	268,383	587,973	533,976	591,890
Interest expense	(325)	(1,488)	(1,915)	(1,926)	(1,860)	(1,600)	(1,933)	(2,070)
Adjustment to fair value of redemption obligation	55,250							
Other	3,644				4,000			
Total other income	69,585	68,841	80,547	99,620	270,523	586,373	532,043	589,820
Income (loss) before provision for income taxes	(1,077,361)	(608,093)	227,021	759,281	1,216,335	1,260,946	1,580,627	2,770,361
Income tax expense (benefit)	(53,700)	(147,103)	82,787	151,957	478,933	470,656	871,277	1,099,597
Net income (loss)	(1,023,661)	(460,990)	144,234	607,324	737,402	790,290	709,350	1,670,764
Convertible preferred stock dividends					348,993	682,813	682,813	691,161
Accretion to redemption value of redeemable convertible preferred stock	402,679	17,751						
Net income (loss) applicable to common stockholders	$ (1,426,340)	$ (478,741)	$ 144,234	$ 607,324	$ 388,409	$ 107,477	$ 26,537	$ 979,603
(1) Excludes acquisition-related consideration, stock-based compensation and amortization of intangible assets								
(2) Components of acquisition-related retention consideration:								
Service costs	$ 15,826	$ 14,604	$ 14,185	$ 71,970	$	$	$	$
Sales and marketing	45,175	41,726	40,503	77,124				
Product development	48,916	45,162	43,865	(1,996)				
General and administrative	23,019	21,232	20,645	(22,876)				
(3) Components of stock-based compensation:								
Service costs	$ 4,050	$ 2,250	$ 2,250	$ 2,250	$ 1,800	$ 132,834	$ (131,034)	$ 900
Sales and marketing	67,546	49,042	7,573	31,573	29,507	285,924	437,983	354,766

Product development	21,902	12,675	12,653	12,653	10,665	137,985	(125,895)	6,040
General and administrative	267,266	171,267	102,929	122,641	104,566	(59,574)	376,904	408,436
(4) Components of amortization of acquired intangible assets from acquisitions:								
Servicecosts	$ 734,868	$ 734,643	$ 978,389	$ 1,072,977	$ 2,393,425	$ 3,890,299	$ 3,795,373	$ 3,704,501
Sales and marketing	162,500	162,500	207,527	168,550	120,833	204,722	448,611	520,834
General and administrative	137,500	137,500	218,548	250,000	568,899	854,630	947,715	979,166

34

Table of Contents

	Quarter ended							
	Mar 31, 2004	June 30, 2004	Sept 30, 2004	Dec 31, 2004	Mar 31, 2005	June 30, 2005	Sept 30, 2005	Dec 31, 2005
Consolidated Statement of Operations Data:								
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Expenses:								
Service costs	62.9	64.8	62.4	61.5	58.0	50.7	52.3	47.2
Sales and marketing	13.3	11.6	9.5	8.0	7.2	7.3	10.8	14.7
Product development	6.7	6.0	4.9	4.3	4.2	6.1	4.5	4.1
General and administrative	9.1	9.6	8.8	9.9	7.9	7.0	5.8	6.5
Acquisition-related retention consideration	1.7	1.4	1.0	0.8				
Facility relocation	3.0		(0.2)					
Stock-based compensation	4.7	2.7	1.0	1.1	0.8	2.3	2.2	2.6
Amortization of intangible assets from acquisitions	13.6	11.7	11.5	9.9	16.8	23.4	20.3	17.5
Total operating expenses	115.1	107.6	98.8	95.6	94.9	96.8	95.9	92.7
Gain on sales of intangible assets, net								0.0
Income (loss) from operations	(15.1)	(7.6)	1.2	4.4	5.1	3.2	4.1	7.3
Other income (expense):								
Interest income	0.1	0.8	0.7	0.7	1.5	2.8	2.1	2.0
Interest expense								
Adjustment to fair value of redemption obligation	0.7							
Other								
Total other income	0.9	0.8	0.7	0.7	1.5	2.8	2.1	2.0
Income (loss) before provision for income taxes	(14.2)	(6.9)	1.9	5.0	6.6	6.0	6.2	9.3
Income tax expense (benefit)	(0.7)	(1.7)	0.7	1.0	2.6	2.2	3.4	3.7
Net income (loss)	(13.5)	(5.2)	1.2	4.0	4.0	3.8	2.8	5.6
Convertible preferred stock dividends					1.9	3.2	2.7	2.3
Accretion to redemption value of redeemable convertible preferred stock	5.3	0.2						
Net income (loss) applicable to common stockholders	(18.8)	(5.4)	1.2	4.0	2.1	0.6	0.1	3.3

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 estimated to be 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

Table of Contents

direct navigation market, for purchase consideration of $164.4 million, including approximately $155.6 million in cash and estimated 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. Net proceeds have been used to fund the Name Development asset acquisition, the Pike Street asset acquisition and the IndustryBrains acquisition and for working capital and other general corporate purposes. We intend to use the remainder of the net proceeds for working capital and other general corporate purposes, including for future acquisitions.

As of December 31, 2005, we had cash and cash equivalents of $63.1 million. As of December 31, 2005, we had contractual obligations of $4.7 million of which $3.6 million is for rent under our facility leases.

Cash provided by operating activities primarily consists of net income (loss) adjusted for certain non-cash items such as depreciation and amortization, tax benefit from stock options, facility relocation amounts, deferred income taxes and changes in working capital. 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 the 2004 and 2005 periods.

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, 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 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.

Table of Contents

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 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, 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, 2005, 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	$ 3,550,728	$ 1,118,658	$ 1,631,315	$ 800,755
Capital leases	70,660	18,337	36,674	15,649
Other contractual obligations	1,044,469	883,149	145,320	16,000
Total contractual obligations [1],[2],[3]	$ 4,665,857	$ 2,020,144	$ 1,813,309	$ 832,404

(1) In February 2005 we entered into (i) a new master agreement with Overture with respect to our direct navigation business, and (ii) a license agreement with 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) From January 1, 2006 through March 29, 2006, the Company incurred other contractual obligations related to minimum contractual payments due to distribution partners totaling approximately $796,000. These commitments relate to 2006 and 2007 and are not included in the above table.

37

During 2005, we paid approximately $12.6 million 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 $1.7 million based upon approximately 142,037 convertible preferred shares outstanding as of March 16, 2006. 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.

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.

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 condensed consolidated financial statements requires us to make

Table of Contents

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, feed management services, and cost-per-action 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 the Company Web sites 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 and other 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.

Table of Contents

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

Our stock-based compensation plan is described more fully in Note 1(m) to the consolidated financial statements. We account for the plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB 25 issued in March 2000, to account for our employee stock options. Under this method, employee compensation expense is recorded on the date of grant only if the fair market value of the underlying stock exceeded the exercise price. SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123) established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans.

As allowed by SFAS 123, we have elected to continue to apply the intrinsic value-based method of accounting described above for options granted to employees, and have adopted the disclosure requirements of SFAS 123. We recognize compensation expense over the vesting period utilizing the accelerated methodology described in Financial Accounting Standards Board Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. We account for non-employee stock-based compensation in accordance with SFAS 123 and EITF No. 96-18.

We used variable plan accounting to account for options to purchase 125,000 shares of our Class B common stock issued under our stock incentive plan that were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period which was February 28, 2004, and, accordingly, we were required to record a compensation charge on a quarterly basis, which lowered our earnings. Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair market value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the option s vesting period. Increases or decreases in the fair market value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense. The amount of stock-based compensation recognized was derived based upon our determination of the fair value of our Class B common stock. We determined the fair value of our Class B common stock based upon a variety of factors, including our operating performance, issuance of our convertible preferred stock, liquidation preference of our preferred stock, and valuations of other publicly-traded companies.

The amount of compensation expense actually recognized in future periods could be lower than currently anticipated if unvested stock options for which deferred compensation has been recorded are forfeited. In addition, if we used different assumptions to determine the deemed fair value of our Class B common stock, we could have reported materially different amounts of stock-based compensation. We currently are not required to record stock-based compensation charges if the employee stock option exercise price or restricted stock purchase price equals or exceeds the deemed fair value of our common stock at the date of grant. Recent changes to applicable accounting standards will require us to record the fair value of options as an expense commencing January 1, 2006. If we had estimated the fair value of options on the date of grant using a Black-Scholes pricing model, and then amortized this estimated fair value over the vesting period of the options, our net income (loss) would have been adversely affected. See Note 1(m) Stock Option Plan and Note 1(s) Recently Issued Accounting Standards of the notes to our consolidated financial statements and elsewhere in this Form 10-KSB for a discussion of how our net income (loss) would be adversely affected.

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 December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123-R (SFAS 123R), *Share-Based Payment,* which replaces SFAS No. 123 (SFAS 123) and supersedes APB Opinion No. 25 (APB 25). As originally issued, SFAS 123 established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that pronouncement permitted entities to continue applying the intrinsic-value-based model of APB 25, provided that the financial statements disclosed the pro forma net income or loss based on the preferable fair-value method.

Table of Contents

We adopted the provisions of SFAS 123R on January 1, 2006. Thus, our consolidated financial statements will reflect an expense for (a) 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 (b) 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. See Note 1(m), Stock Option Plan for the pro forma net income (loss) and net income (loss) per share amounts, for the year ended December 31, 2004 and 2005, as if we had applied the fair value recognition provisions of SFAS 123 to measure compensation cost for employee stock incentive awards. Upon adoption during the quarter ended March 31, 2006, we will recognize stock-based compensation using the modified prospective method and expect the adoption to have a material adverse impact on our consolidated financial statements. The magnitude of this impact will depend on a number of factors, including the timing and magnitude of new stock awards, the number and type of new awards, changes in the market price or volatility of our Class B common stock and preferred stock, as well as unanticipated changes in our workforce.

We will recognize stock-based compensation after the date of adoption of SFAS 123R using the straight-line method for all stock awards issued after January 1, 2006, which will result in the recognition of less stock-based compensation over at least the next several years compared to that which would have been recognized had we continued to use the accelerated method.

SFAS 123R requires that the deferred stock-based compensation on our consolidated statement of stockholders equity on the date of adoption be netted against paid-in capital. At December 31, 2005, we had $3.0 million of deferred stock-based compensation on our consolidated statement of stockholders equity.

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a cash flow from financing activities, rather than as a cash flow from operating activities, as was prescribed under accounting rules applicable through December 31, 2005 and presented as tax benefits from stock-based award activity on the accompanying consolidated statements of cash flows. This requirement will likely significantly reduce and increase the amounts we record as net cash provided by operating activities and net cash provided by financing activities, respectively. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107. In accordance with this Bulletin, effective January 1, 2006 we will no longer present stock-based compensation separately on our statements of income. Instead we will present stock-based compensation in the same lines as cash compensation paid to the same individuals.

In May 2005, the FASB issued Statement No. 154, Accounting Changes and Error Corrections , a replacement of Accounting Principles Board Opinion No. 20, Accounting Changes , and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements (SFAS 154). The new statement changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements.

Table of Contents

RISK FACTORS

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.

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 $2.8 million as of December 31, 2005. While we recently achieved profitability, we may not be able to sustain it. 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 are required to expense the fair value of stock options granted.

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 11% of our total revenue for the year ended December 31, 2005. Separately, Yahoo! Search Marketing was responsible for 23% of our total revenue during the same period principally in respect of the revenues associated with our portfolio of domains.

Our existing agreements with many of our 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 any one large distribution partner could have a material adverse effect on our business, financial condition and results of operations.

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 November 2005, Yahoo! Search accounted for 30% of the online searches in the United States and Google accounted for 40%. 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 civil claims 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 required contractually to use the merchant listings that we provide in accordance with applicable laws and regulations and in conformity with our 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.

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

Table of Contents

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 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. Low-quality traffic may further prevent us from growing our base of merchant advertisers and cause us to lose relationships with existing merchant advertisers which could 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 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.

Table of Contents

- 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 142,137 shares of preferred stock outstanding following the conversions into shares of Class B common stock that have occurred to date.

- 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;