

MARCHEX INC  
Form 10-Q  
May 10, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2007

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

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**Marchex, Inc.**

(Exact name of Registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

413 Pine Street, Suite 500  
Seattle, Washington 98101

35-2194038  
(I.R.S. Employer  
Identification No.)

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(Address of principal executive offices)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Class	Outstanding at May 9, 2007
Class A common stock, par value \$.01	11,659,216
Class B common stock, par value \$.01	30,351,860

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**Marchex, Inc.**

**Form 10-Q**

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**Table of Contents****Part I Financial Information****Item 1. Condensed Consolidated Financial Statements (unaudited)  
MARCHEX, INC. AND SUBSIDIARIES**

## Condensed Consolidated Balance Sheets

(unaudited)

	December 31, 2006	March 31, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 46,105,827	\$ 59,066,957
Accounts receivable, net	22,035,343	18,904,030
Prepaid expenses and other current assets	2,221,550	1,768,818
Refundable taxes	1,837,166	2,434,383
Deferred tax assets	670,624	489,827
Total current assets	72,870,510	82,664,015
Property and equipment, net	7,280,075	8,050,690
Deferred tax assets	2,444,782	3,816,267
Intangible and other assets, net	13,318,801	11,575,234
Goodwill	200,738,098	195,709,714
Intangible assets from acquisitions, net	36,735,570	31,986,245
Total assets	\$ 333,387,836	\$ 333,802,165
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 10,739,231	\$ 10,610,630
Accrued expenses and other current liabilities	2,913,152	2,309,130
Deferred revenue	2,430,644	2,464,308
Total current liabilities	16,083,027	15,384,068
Other non-current liabilities	91,907	83,435
Total liabilities	16,174,934	15,467,503
Commitments, contingencies, and subsequent events		
Stockholders equity:		
Convertible preferred stock	2,342,884	1,664,827
Class A common stock	119,217	119,217
Class B common stock	276,361	301,895
Additional paid-in capital	320,607,113	321,960,836
Accumulated deficit	(6,132,673)	(5,712,113)
Total stockholders equity	317,212,902	318,334,662
Total liabilities and stockholders equity	\$ 333,387,836	\$ 333,802,165

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See accompanying notes to condensed consolidated financial statements.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES**

## Condensed Consolidated Statements of Operations

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2007</b>
Revenue	\$ 31,112,325	\$ 34,223,401
Expenses:		
Service costs (1), (2)	14,851,949	15,241,228
Sales and marketing (1), (2)	5,866,684	7,509,921
Product development (1), (2)	2,227,024	2,597,656
General and administrative (1), (2)	3,409,508	4,180,775
Amortization of intangible assets from acquisitions (3)	4,870,673	4,523,134
Total operating expenses	31,225,838	34,052,714
Gain (loss) on sales and disposals of intangible assets, net	179,208	32,264
Income from operations	65,695	202,951
Other income (expense):		
Interest income	738,356	708,495
Interest expense	(2,211)	(1,792)
Other	(1,863)	5,284
Total other income	734,282	711,987
Income before provision for income taxes	799,977	914,938
Income tax expense	653,648	473,788
Income before cumulative effect of change in accounting principle	146,329	441,150
Cumulative effect of a change in accounting principle, net of tax	151,341	
Net income	297,670	441,150
Convertible preferred stock dividends, conversion payment, and discount on preferred stock redemption, net	1,493,935	(106,548)
Net income (loss) applicable to common stockholders	\$ (1,196,265)	\$ 547,698
Basic and diluted net income (loss) per share applicable to common stockholders	\$ (0.03)	\$ 0.01
Shares used to calculate basic net income (loss) per share applicable to common stockholders	37,124,298	39,165,916
Shares used to calculate diluted net income (loss) per share applicable to common stockholders	37,124,298	40,417,741
(1) Excludes amortization of intangible assets from acquisitions		
(2) Includes stock-based compensation as follows:		
Service costs	\$ 236,211	\$ 118,535
Sales and marketing	\$ 1,047,271	372,358
Product development	\$ 735,187	489,252
General and administrative	\$ 1,502,074	1,907,069
Total	\$ 3,520,743	\$ 2,887,214
(3) Components of amortization of intangible assets from acquisitions:		

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Service costs	\$ 3,370,673	\$ 3,222,866
Sales and marketing	\$ 520,833	715,000
General and administrative	\$ 979,167	585,268
Total	\$ 4,870,673	\$ 4,523,134

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES**

## Condensed Consolidated Statements of Cash Flows

(unaudited)

	Three Months Ended	
	2006	March 31, 2007
Cash flows from operating activities:		
Net income	\$ 297,670	\$ 441,150
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of a change in accounting principle	(151,341)	
Amortization and depreciation	6,168,901	6,424,156
Facility relocation recoveries	(17,643)	
Gain (loss) on sales of fixed assets	1,863	(5,284)
Gain (loss) on sales and disposals of intangible assets, net	(179,208)	(32,264)
Allowance for doubtful accounts and merchant advertiser credits	174,751	(223,930)
Stock-based compensation	3,520,743	2,887,214
Deferred income taxes	(733,150)	(1,190,688)
Excess tax benefit related to stock options	(1,477,965)	(1,492,991)
Change in certain assets and liabilities, net of acquisition:		
Trade accounts receivable, net	629,559	3,355,244
Refundable taxes	1,503,097	1,172,938
Prepaid expenses, other current assets, and restricted cash	(503,201)	1,036,845
Accounts payable	92,033	(105,379)
Accrued expenses and other current liabilities	125,231	181,826
Deferred revenue	(25,507)	32,926
Other non current liabilities	4,266	(3,641)
Net cash provided by operating activities	9,430,099	12,478,122
Cash flows from investing activities:		
Purchases of property and equipment	(1,521,974)	(1,584,057)
Cash paid, net of recoveries, for acquisitions	371,850	(375)
Proceeds from sales of property and equipment	2,170	17,794
Proceeds from sales of intangible assets	613,955	155,006
Increase in other non current assets	(281,128)	(93,775)
Net cash used in investing activities	(815,127)	(1,505,407)
Cash flows from financing activities:		
Capital lease obligation principal paid	(2,611)	(3,536)
Excess tax benefit related to stock options	1,477,965	1,492,991
Preferred stock dividends and conversion payment	(1,632,441)	(20,591)
Preferred stock buy back		(555,113)
Common stock dividends		(831,973)
Proceeds from exercises of stock options	952,910	1,872,390
Proceeds from employee stock purchase plan	23,197	34,247
Net cash provided by financing activities	819,020	1,988,415
Net increase in cash and cash equivalents	9,433,992	12,961,130
Cash and cash equivalents at beginning of period	63,090,941	46,105,827



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Cash and cash equivalents at end of period	\$ 72,524,933	\$ 59,066,957
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See accompanying notes to condensed consolidated financial statements.

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**Marchex, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**(1) Description of Business and Basis of Presentation**

Marchex, Inc. (the Company) was incorporated in the state of Delaware on January 17, 2003. The Company is a technology driven search and media company focused on vertical and local online traffic. Specifically, the Company focuses on search marketing, local search, and operating a proprietary network of Web sites. The Company's platform of integrated performance-based advertising and search marketing services enables merchants to efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and selected Web sites.

The accompanying unaudited condensed consolidated financial statements of Marchex, Inc. and its wholly-owned subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the year ended December 31, 2007, or for any other period. The balance sheet at December 31, 2006 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements and accompanying notes included in the Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC.

The condensed consolidated financial statements include the accounts of Marchex and its wholly-owned subsidiaries. Acquisitions are included in the Company's consolidated financial statements as of the date of acquisition. The Company's purchase accounting resulted in all assets and liabilities of acquired businesses being recorded at their estimated fair values on the acquisition dates. All significant inter-company transactions and balances have been eliminated in consolidation. Certain reclassifications have been made to the condensed consolidated financial statements in the prior year to conform to the current year presentation.

The Company's condensed consolidated financial statements presented include the balance sheets as of December 31, 2006 and March 31, 2007, the consolidated statements of operations for the three months ended March 31, 2006 and 2007, and the consolidated statements of cash flows for the three months ended March 31, 2006 and 2007.

***Acquisitions***

The Company has completed the following acquisitions since January 1, 2006 and has accounted for them as business combinations:

On May 1, 2006, the Company acquired certain assets of AreaConnect LLC (AreaConnect), a provider of local online traffic to Yellow and White Pages publishers.

On May 26, 2006, the Company acquired certain assets of Open List, Inc. (Open List), including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(2) Significant Accounting Policies**

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These judgments are difficult as matters that are inherently uncertain directly impact their valuation and accounting. Actual results may vary from management's estimates and assumptions.

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC.

**Stock-based Compensation**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123-R (SFAS 123R), *Share-Based Payment*, which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock issued to Employees*. The adoption of SFAS 123R had a material impact on the Company's consolidated financial statements. See Note 3 Stock-based Compensation Plans for further information regarding the Company's adoption of SFAS 123R.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to application of SFAS 123R. In accordance with SAB 107, the Company presents stock-based compensation in the same lines as compensation paid to the same individuals on the consolidated statements of operations.

**Recently Issued Accounting Pronouncements**

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

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

**Revenues**

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

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2007</b>
Proprietary Traffic Sources	\$ 11,301,167	\$ 15,115,924
Partner and Other Revenue Sources	19,811,158	19,107,477
<b>Total Revenue</b>	<b>\$ 31,112,325</b>	<b>\$ 34,223,401</b>



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**Marchex, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

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

**(3) Stock-based Compensation Plans**

SFAS 123 established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. 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. From inception through December 31, 2005, the Company applied the intrinsic value-based method of accounting prescribed by APB 25 and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation an interpretation of APB Opinion No. 25* issued in March 2000, to account for its employee stock options and restricted stock grants. Under this method, employee compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

Through December 31, 2005, the Company recognized compensation expense over the vesting period utilizing the accelerated methodology described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

In December 2004, the FASB issued SFAS 123R, which replaces SFAS 123 and supersedes APB 25. The Company began applying SFAS 123R as of January 1, 2006, using the modified prospective application method. As a result, the Company's consolidated financial statements 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 estimated in accordance with the pro forma provisions of SFAS 123. Under the modified prospective application method, the Company's consolidated financial statements for periods prior to the first quarter of 2006 have not been restated. Upon adoption of SFAS 123R, the Company recognized a one-time gain from the cumulative effect of a change in accounting principle, net of tax, of \$151,000 based on SFAS 123R's requirement to apply an estimated forfeiture rate to unvested awards. Previously, the Company had recorded forfeitures as incurred.

Under SFAS 123R, the Company recognizes stock-based compensation expense using the straight-line method for all stock awards issued after January 1, 2006, which results in the recognition of less stock-based compensation expense over at least the next several years compared to that which would have been recognized had the Company continued to use the accelerated method.

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

SFAS 123R requires that the deferred stock-based compensation on the Company's balance sheet on the date of adoption be netted against paid-in capital. On January 1, 2006, the Company netted approximately \$3.0 million of the outstanding deferred stock-based compensation against paid-in capital on the balance sheet.

Prior to adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating inflows in the consolidated statements of cash flows, in accordance with the provisions of the Emerging Task Force (ETF) issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*. SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is shown as "Excess tax benefit related to stock options" on the consolidated statement of cash flows.

**Stock Based Compensation Plans**

The per share fair value of stock options granted during the three months ended March 31, 2007 was determined on the date of grant using the Black Scholes option-pricing model with the following assumptions:

	<b>2007</b>
Expected life (in years)	4.0
Risk-free interest rate	4.54%
Expected volatility	52%
Expected dividend yield	0.6%

Stock option activity during the three months ended March 31, 2007 is summarized as follows:

	Options available for grant	Number of options outstanding	Weighted average exercise price of options outstanding	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance at December 31, 2006	1,165,977	5,660,405	\$ 12.38	8.08	\$ 18,124,479
Increase to option pool January 1, 2007	1,969,742				
Granted equal to or above fair value	(137,700)	137,700	\$ 13.20		
Options exercised		(556,565)	\$ 3.30		
Options canceled	313,751	(313,751)	\$ 15.24		
Options forfeited	32,843	(32,843)	\$ 15.54		
Balance at March 31, 2007	3,344,613	4,894,946	\$ 13.22	7.46	\$ 17,411,591

Restricted Stock activity during the three months ended March 31, 2007 is summarized as follows:

	Shares	Weighted Average Grant Date Fair Value
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Unvested at December 31, 2006	252,466	\$	18.92
Granted	2,300,000	\$	13.38
Vested	(58,594)	\$	17.00
Canceled	(752)	\$	17.00
Unvested at March 31, 2007	2,493,120	\$	13.79

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In October 2006, the compensation committee of the Company's board of directors resolved to approve effective January 1, 2007 grants to certain executives of 2.3 million of restricted Class B common stock which vest over a six year period. Stock-based compensation expense will be recognized over the vesting period of these grants.

The following table summarizes stock-based compensation expense related to all stock-based awards under SFAS 123R during the three months ended March 31, 2006 and 2007:

	2006	2007
Stock-based compensation:		
Total stock-based compensation included in net income (loss)	\$ 3,521,000	\$ 2,887,000
Income tax benefit related to stock-based compensation included in net income (loss)	\$ 453,000	\$ 747,000

**(4) Net Income (Loss) Per Share**

The Company's basic and diluted net income (loss) per share is presented for the three months ended March 31, 2006 and 2007. Basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the year. Diluted net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive net income (loss) per share includes the cumulative effective of change in accounting principle, net of tax and excludes convertible stock dividends, conversion payment and discount on redemption of preferred stock and includes shares that the preferred stock is convertible into if the result is dilutive.

The following table reconciles the Company's reported net income (loss) to net income (loss) applicable to common stockholders used to compute basic and diluted net income (loss) per share for the periods ended:

	For the three months ended March 31,	
	2006	2007
Numerator:		
Net income before cumulative effect of change in accounting principle	\$ 146,329	\$ 441,150
Cumulative effect of change in accounting principle, net of taxes	151,341	
Convertible preferred stock dividends and conversion payment	(1,493,935)	(16,396)
Discount on redemption of preferred stock		122,944
Net income (loss) applicable to common stockholders	\$ (1,196,265)	\$ 547,698
Denominator:		
Weighted average number of shares outstanding excluding unvested common shares subject to repurchase or cancellation	37,124,298	39,165,916
Basic net income (loss) per share applicable to common stockholders	\$ (0.03)	\$ 0.01



**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table reconciles the Company's reported net income (loss) to diluted net income (loss) applicable to common stockholders used to compute diluted net income (loss) per share for the periods ended:

	For the three months ended March 31,	
	2006	2007
<b>Numerator:</b>		
Net income before cumulative effect of change in accounting principle	\$ 146,329	\$ 441,150
Cumulative effect of change in accounting principle, net of taxes	151,341	
Convertible preferred stock dividends and conversion payment	(1,493,935)	(16,396)
Convertible preferred stock dividends on redeemed preferred stock		
 Net income (loss) applicable to common stockholders	 \$ (1,196,265)	 \$ 424,754
<b>Denominator:</b>		
Weighted average number of common shares outstanding excluding unvested common shares subject to repurchase or cancellation	37,124,298	39,165,916
Weighted average stock options and warrants and common shares subject to repurchase or cancellation		1,250,221
Weighted average number of shares from assumed conversion of preferred stock redeemed		1,604
 Weighted average number of shares to calculate diluted net income (loss) per share applicable	 37,124,298	 40,417,741
 Diluted net income (loss) per share applicable to common stockholders	 \$ (0.03)	 \$ 0.01

For the three months ended March 31, 2006, the net loss applicable to common stockholders used in computing basic net loss per share applicable to common stockholders included the cumulative effect of change in accounting principle, net of tax, related to the adoption of SFAS 123R on January 1, 2006, preferred stock dividends, and the conversion payment of approximately \$970,000 related to the conversion of 80,848 preferred shares of the Company's 4.75% convertible exchangeable preferred stock. For the three months ended March 31, 2006, the net loss applicable to common stockholders used in computing basic net loss per share was the same for computing diluted net loss per share.

For the three months ended March 31, 2007, the net income applicable to common stockholders used in computing basic net income per share applicable to common stockholders included the preferred stock dividends and the discount on the redemption of 2,825 shares of the Company's 4.75% convertible exchangeable preferred stock of approximately \$123,000. The diluted net income applicable to common stockholders excluded the discount on the preferred stock redemption and any convertible stock dividends paid during the period on the redeemed shares. The discount on the preferred stock redemption is the difference between the carrying value per share of the redeemed preferred shares and the \$195 per share (plus commissions) paid by the Company to the preferred stockholders. Total cash consideration paid to the preferred stockholders was approximately \$555,000. The weighted average number of shares used to calculate the diluted net income per share includes the weighted average number of shares from the assumed conversion of the redeemed preferred stock.

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**Marchex, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The computation of diluted net income (loss) per share excludes the following because their effect would be anti-dilutive:

For the three months ended March 31, 2006 and 2007, 1,450,377 shares and 72,450 shares, respectively, issuable upon conversion of the 4.75% convertible preferred stock issued in connection with the February 2005 follow-on public offering.

For the three months ended March 31, 2006, outstanding options to acquire 5,692,168 shares of Class B common stock with a weighted average exercise price of \$11.50 per share and for the three months ended March 31, 2007, outstanding options to acquire 1,976,887 shares of Class B common stock with a weighted average exercise price of \$10.12 per share.

For the three months ended March 31, 2006, warrants to acquire 6,500 shares of Class B common stock at an exercise price of \$8.45.

For the three months ended March 31, 2006, 265,410 shares of unvested Class B restricted common shares at March 31, 2006 issued to employees in connection with acquisitions. These shares were for future services that vest over periods ranging from two and one-half to three years. Unvested shares were excluded from the computation of basic net loss per share for the three months ended March 31, 2006.

**(5) Concentrations**

The Company maintains substantially all of their cash and cash equivalents with one financial institution.

A substantial majority of the Company's revenue earned from merchant advertisers is generated through arrangements with distribution partners. The Company may not be successful in renewing any of these agreements, or if they are renewed, they may not be on terms as favorable as current agreements. The Company may not be successful in entering into agreements with new distribution partners on commercially acceptable terms. In addition, several of these distribution partners may be considered potential competitors.

There were no distribution partners representing more than 10% of consolidated revenue for the period ended March 31, 2006 and 2007.

There is one distribution partner who is also a merchant advertiser that represented approximately 28% and 39% of revenue for the three months ended March 31, 2006 and 2007, respectively. This same merchant advertiser represented approximately 41% and 47% of the outstanding accounts receivable balance at December 31, 2006 and March 31, 2007, respectively. There was one other merchant advertiser representing 11% of the outstanding receivable balance at March 31, 2007.

**(6) Segment Reporting and Geographic Information**

Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company's management. For all periods presented the Company operated as a single segment. The Company operates in a single operating segment principally in domestic markets providing Internet merchant transaction services to enterprises.

Revenues from merchant advertisers by geographical areas are tracked on the basis of the location of the merchant advertiser. The vast majority of the Company's revenue and accounts receivable are derived from domestic sales to advertisers engaged in various activities involving the Internet.



**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Revenues by geographic region are as follows (in percentages):

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2007</b>
United States	93%	97%
Canada	2%	1%
Other countries	5%	2%
	100%	100%

**(7) Property and Equipment**

Property and equipment consisted of the following:

	<b>As of</b>	<b>As of</b>
	<b>December 31,</b>	<b>March 31,</b>
	<b>2006</b>	<b>2007</b>
Computer and other related equipment	\$ 4,330,528	\$ 5,155,092
Purchased and internally developed software	6,215,940	6,940,113
Furniture and fixtures	287,962	299,343
Leasehold improvements	128,512	130,584
	\$ 10,962,942	\$ 12,525,132
Less accumulated depreciation and amortization	(3,682,867)	(4,474,442)
<b>Property and equipment, net</b>	<b>\$ 7,280,075</b>	<b>\$ 8,050,690</b>

The Company has capitalized certain costs of internally developed software for internal use. The estimated useful life of costs capitalized is evaluated for each specific project. Amortization begins in the period in which the software is ready for its intended use. The Company had \$1.9 million and \$1.0 million of internally developed software costs that had not commenced amortization as of December 31, 2006 and March 31, 2007, respectively.

Depreciation and amortization expense incurred by the Company was approximately \$312,000 and \$777,000 for the three months ended March 31, 2006 and 2007, respectively.

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(8) Commitments**

The Company has commitments for future payments related to office facilities leases, equipment and furniture leases, and other contractual obligations. The Company leases its office facilities under operating lease agreements expiring through 2010. The equipment and furniture leases are financed through capital lease arrangements and are included in property and equipment and the related depreciation is recorded as depreciation expense. The Company also has other contractual obligations expiring over varying time periods through 2009. Other contractual obligations primarily relate to minimum contractual payments due to distribution partners and other service providers. Future minimum payments are as follows:

	<b>Equipment and furniture capital leases</b>	<b>Facilities operating leases</b>	<b>Other contractual obligations</b>	<b>Total</b>
2007	16,878	1,047,848	1,003,465	2,068,191
2008	22,289	1,296,955	452,288	1,771,532
2009	19,601	1,110,524	114,202	1,244,327
2010		169,294		169,294
<b>Total minimum payments</b>	<b>\$ 58,768</b>	<b>\$ 3,624,621</b>	<b>\$ 1,569,955</b>	<b>\$ 5,253,344</b>
Less: amounts representing interest	(10,256)			
<b>Present value of lease obligation</b>	<b>48,512</b>			
Less current portion	(16,211)			
<b>Long-term portion</b>	<b>\$ 32,301</b>			

Rent expense incurred by the Company was approximately \$254,000 and \$319,000 for the three months ended March 31, 2006 and 2007, respectively.

In connection with the closing of the Name Development asset acquisition in 2005, the Company entered into (i) a new master agreement with an advertising partner with respect to the Company's network of Internet domain names, and (ii) a license agreement with the same partner with respect to certain of the partner's patents, pursuant to which the Company paid \$4.5 million in an upfront payment (and an additional \$674,000 in certain circumstances) and a contingent royalty based upon a discounted rate of 3% (3.75% under certain circumstances) of certain of the Company's gross revenues payable on a quarterly basis through December 2016. The royalty payment is recognized as incurred in service costs.

**(9) Contingencies and Taxes****(a) Contingencies**

The Company is involved in legal and administrative proceedings and claims of various types from time to time. While any litigation contains an element of uncertainty, the Company is not aware of any legal proceedings or claims which are pending that the Company believes, based on current knowledge, will have, individually or taken together, a material adverse effect on the Company's financial condition or results of operations.

**(b) Taxes**

From time to time, various state, federal and other jurisdictional tax authorities undertake reviews of the Company and its filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. The Company

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believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

The Company did not have any material amounts of unrecognized tax benefits as of the adoption date and March 31, 2007. Also, the Company did not have any material amounts of unrecognized tax benefits that, if recognized, would affect the Company's effective tax rate.

The Company files U.S. federal, certain U.S. states, and certain foreign tax returns. Generally, U.S. federal, U.S. state, and foreign tax returns filed for years after 2003 are within the statute of limitations and remain subject to examination.

**(10) AreaConnect Asset Acquisition**

On May 1, 2006, the Company acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers. The purchase price consideration consisted of:

\$12.2 million in cash and estimated acquisition costs; plus

183,832 shares of Class B common stock; plus

78,129 shares of restricted Class B common stock that vest over a period of 3 years.

The Company accounted for the AreaConnect asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted traffic.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately \$3.9 million. The shares of restricted Class B common stock were valued at \$21.39 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$1.7 million. The 78,129 shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company. The shares vest over a period of three years from the closing date, with the first 16.67% vesting after six months and each additional 16.67% vesting each successive 6-month period over the next thirty months. These restricted shares were valued at approximately \$1.7 million and will be amortized on a straight-line basis as stock-based compensation expense, net of estimated forfeitures, over the associated three-year employment period over which those shares vest.

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

The following summarizes the estimated fair value of the assets acquired at the date of acquisition:

Intangible assets	\$ 3,520,000
Goodwill	12,648,882

Total assets acquired	\$ 16,168,882
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**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In connection with the acquisition, \$1.2 million of the cash consideration, 55,609 shares of Class B common stock, and 11,719 shares of restricted Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts have been included as part of the purchase price consideration and were released upon termination of the escrow period.

The acquired intangible assets in the amount of \$3.5 million have a weighted average useful life of approximately 2.6 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of a non-compete agreement with a value of approximately \$400,000 (3-year weighted average useful life), domain names with a value of approximately \$20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately \$1.0 million (1.5-year weighted average useful life) and acquired technology with a value of approximately \$2.1 million (3-year weighted average useful life). The goodwill of \$12.7 million and the acquired intangible assets with a value of \$3.5 million are deductible over 15 years for federal tax purposes.

**(11) Open List Asset Acquisition**

On May 26, 2006, the Company acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform. The purchase price consideration consisted of:

\$6.3 million in cash and estimated acquisition costs; plus

286,254 shares of Class B common stock; plus

114,502 shares of restricted Class B common stock that vest over a period of two and one-half years.

The Company accounted for the Open List asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately \$5.0 million. The shares of restricted Class B common stock were valued at \$17.58 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$2.0 million. The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company. The shares vest over a period of two and one-half years from the closing date, with the first 20.0% vesting after six months and each additional 20.0% vesting each successive 6-month period over the next twenty-four months. These restricted shares were valued at approximately \$2.0 million and will be amortized on a straight-line basis as stock-based compensation expense, net of estimated forfeitures, over the associated two and one-half year employment periods over which those shares vest.

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

The following summarizes the preliminary estimated fair value of the assets acquired at the date of acquisition:

Property and equipment	\$ 10,000
Intangible assets	3,520,000
Goodwill	7,833,629

Total assets acquired

\$ 11,363,629

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from Open List. The foregoing estimates may be subject to adjustment upon the completion of the Company's final review and assessment of the fair value of the assets included in the acquisition.

In connection with the acquisition, \$600,000 of the cash consideration and 40,076 shares of Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts are included as part of the purchase price consideration. In the event any indemnification obligations are identified, the purchase price will be reduced accordingly. The escrow amounts, less any indemnification obligations identified, will be released upon termination of the escrow period.

The acquired intangible assets in the amount of \$3.5 million have a weighted average useful life of approximately 3.1 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of non-compete agreements with a value of approximately \$400,000 (2-year weighted average useful life), domain names with a value of approximately \$20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately \$900,000 (2.5-year weighted average useful life) and acquired technology with a value of approximately \$2.2 million (3.5-year weighted average useful life). The goodwill of \$7.8 million and the acquired intangible assets with a value of \$3.5 million are deductible over 15 years for federal tax purposes.

**(12) Intangible Assets from Acquisitions**

Intangible assets from acquisitions consisted of the following:

	<b>December 31, 2006</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Merchant advertiser customer base	\$ 8,900,000	\$ (4,980,251)	\$ 3,919,749
Distribution partner base	3,100,000	(2,496,057)	603,943
Non-compete agreements	9,900,000	(8,484,192)	1,415,808
Trademarks/domains	44,557,779	(19,467,492)	25,090,287
Acquired technology	15,700,000	(9,994,217)	5,705,783
	\$ 82,157,779	\$ (45,422,209)	\$ 36,735,570
	<b>March 31, 2007</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Merchant advertiser customer base	\$ 8,900,000	\$ (5,695,251)	\$ 3,204,749
Distribution partner base	3,100,000	(2,629,391)	470,609
Non-compete agreements	9,900,000	(9,069,460)	830,540
Trademarks/domains	43,936,353	(21,437,980)	22,498,373
Acquired technology	15,700,000	(10,718,026)	4,981,974
	\$ 81,536,353	\$ (49,550,108)	\$ 31,986,245

Amortizable intangible assets are amortized on a straight-line basis over their useful lives. Aggregate amortization expense incurred by the Company for the three months ended March 31, 2006 and 2007, was approximately \$4.9 million and \$4.5 million, respectively. Based upon the current amount of intangible assets subject to amortization, the estimated amortization expense for the next five years is as follows: \$11.7

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million for the remainder of 2007, \$12.0 million in 2008, \$4.1 million in 2009, \$2.3 million in 2010, and \$1.9 million in 2011 and thereafter.

**Table of Contents****Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(13) Goodwill**

Changes in the carrying amount of goodwill for the three months ended March 31, 2007 are as follows:

Balance as of December 31, 2006	\$ 200,738,098
Name Development consideration adjustment	(5,028,384)
<b>Balance as of March 31, 2007</b>	<b>\$ 195,709,714</b>

In connection with the Name Development Ltd asset acquisition in 2005, \$24.6 million of the cash consideration was placed in escrow to secure indemnification obligations for a period of 18 months from the closing date. The escrow amounts were included as part of the purchase price consideration. A net amount of \$357,000 was released from escrow in March 2006 in satisfaction of certain intangible asset indemnification obligations. This amount was reflected as an adjustment to goodwill in 2006. In 2007, in satisfaction of certain intangible asset indemnification obligations, a net amount of 250,000 Class B common shares were returned by the seller to the Company and reflected as a \$5.0 million and \$219,000 adjustment to goodwill and intangible assets, respectively, and the remaining balance in escrow was released to the seller. The share adjustment was based on the transaction per share value determined at acquisition.

**(14) Intangible and other assets, net**

Intangible and other assets, net consisted of the following:

	As of December 31, 2006	As of March 31, 2007
Internet domain names	\$ 14,458,880	\$ 14,564,472
Less accumulated amortization	(5,061,457)	(5,749,484)
<b>Other intangible assets, net</b>	<b>9,397,422</b>	<b>8,814,988</b>
Other assets:		
License fee	4,500,000	4,500,000
Less accumulated amortization	(2,414,541)	(2,735,969)
<b>License fee, net</b>	<b>2,085,459</b>	<b>1,764,031</b>
Restricted cash	800,000	75,000
Registration fees, net	819,373	711,659
Other	216,546	209,556
<b>Total intangibles and other assets, net</b>	<b>\$ 13,318,801</b>	<b>\$ 11,575,234</b>

The Company capitalizes costs incurred to acquire domain names or URLs, which include the initial registration fees, to other intangible assets which excludes intangible assets acquired through business combinations. The capitalized costs are amortized over the expected useful life of the domain names on a straight-line basis. Based upon the current amount of domains subject to amortization, the estimated expense for the next five years is as follows: \$2.1 million for the remainder of 2007, \$2.3 million in 2008, \$1.7 million in 2009, \$1.3 million in 2010, and \$1.4 million in 2011 and thereafter. There were domains held for sale valued at approximately \$121,000 and \$5,500 under prepaid expenses and other current assets as of December 31, 2006 and March 31, 2007, respectively, which are no longer being amortized.

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In 2005, the Company entered into a license agreement with an advertising partner with respect to certain of such advertising partner's patents, pursuant to which the Company paid \$4.5 million in an upfront payment (and

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**Marchex, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

an additional \$674,000 in certain circumstances) and a contingent royalty based upon a discounted rate of 3% (3.75% under certain circumstances) of certain of the Company's gross revenues payable on a quarterly basis through December 2016. The upfront license fee was capitalized and is being amortized ratably over 42 months.

**(15) Convertible Preferred Stock and Common Stock**

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 824,980 shares of the Company's Class B common stock at a conversion rate of \$24.50 per share and received a cash payment from the Company of \$12.00 per share of preferred stock for an aggregate amount of approximately \$970,000 in order to induce conversions. The \$970,000 was reflected as preferred stock dividends, conversion payment, and discount on preferred stock redemption in the Company's financial statements.

In January 2007, the Company repurchased 2,825 shares of preferred stock for a total cash expenditure of approximately \$555,000. The Company recorded a discount on the preferred stock redemption of approximately \$123,000 which is the difference between the carrying value per share of the redeemed preferred shares and the \$195 per share (plus commissions) paid by the Company to the preferred stockholders. The \$123,000 was reflected as preferred stock dividends, conversion payment, and discount on preferred stock redemption in the Company's financial statements. Approximately 6,933 shares of preferred stock remain outstanding as of March 31, 2007.

In November 2006, we initiated a quarterly cash dividend at \$0.02 per share of Class A common stock and Class B common stock which was paid on February 15, 2007 to stockholders of record as of the close of business on February 2, 2007. The aggregate quarterly dividend paid was approximately \$832,000.

**(16) Subsequent Events**

In April 2007, the Company subleased one of its office locations. In connection with the sublease, the Company accrued for lease and related costs of approximately \$110,000 for the estimated future obligations of non-cancelable lease and other costs related to the office during the quarter ending June 30, 2007. The 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, the estimates may be adjusted in future periods.

In April 2007, the Company's board of directors declared a regular quarterly dividend in the amount \$0.02 per share on the Company's Class A and Class B common stock and \$2.97 per share on the Company's 4.75% convertible exchangeable preferred stock. The Company will pay these dividends on May 15, 2007 to the holders of record as of the close of business on May 4, 2007.

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

*This Quarterly Report on Form 10-Q 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. 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 but not limited to the risks, uncertainties and assumptions described in this report, in Part II, Item 1A. under the caption Risk Factors and elsewhere in our Annual Report on Form 10-K for the year ended December 31, 2006, and those described from time to time in our future reports filed with the SEC. 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.*

*The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our results of operation and financial condition. You should read this analysis in conjunction with the attached condensed consolidated financial statements and related notes thereto, and with our audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-K for the year ended December 31, 2006.*

**Overview**

We are a technology driven search and media company focused on vertical and local online traffic. Specifically, we focus on search marketing, local search, and operating a proprietary network of Web sites. Our network of vertical and local Web sites provide online users with: (1) information relating to specific products or services; and (2) relevant advertisers who sell such products or services. Our platform of search marketing services enables merchants to efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and selected Web sites.

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

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

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

**Pay-Per-Click Targeting.** We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries, and in response to their typing of specific Web sites into their browser. 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



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distribution network of search engines, product shopping engines, directories, certain third-party Web sites and our proprietary network of Web sites. We also generate revenue from cost-per-action services. Cost-per-action revenue occurs when the online user is redirected from one of our Web sites or a third-party Web site in our distribution network to a merchant advertiser Web site and completes a specified action.

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

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

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

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

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

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

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

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

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

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

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

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

On May 26, 2006, we acquired certain assets of Open List, which was incorporated in Delaware on November 18, 2003. We currently have offices in Seattle, Washington; Eugene, Oregon; Las Vegas, Nevada; and New York, New York.

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### **Acquisitions**

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

#### ***AreaConnect***

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

\$12.2 million in cash and estimated acquisition costs; plus

183,832 shares of Class B common stock; plus

78,129 shares of restricted Class B common stock that vest over a period of 3 years.

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

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

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

#### ***Open List***

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

\$6.3 million in cash and estimated acquisition costs; plus

286,254 shares of Class B common stock; plus

114,502 shares of restricted Class B common stock that vest over a two and one-half year period from the closing date in installments of 20% after each six month period during that term.

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

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

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

#### ***Consolidated Statements of Operations***

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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.

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### ***Presentation of Financial Reporting Periods***

The comparative periods presented are for the three months ended March 31, 2006 and 2007.

### ***Revenue***

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

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services, cost-per-action services and feed management services. These primary sources amounted to greater than 90% 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 10% of our revenues in all periods presented. We have no barter transactions.

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

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

### ***Performance-Based Advertising Services***

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

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

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

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### ***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.

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' index of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

### ***Outsourced Search Marketing Platforms***

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

### ***Industry and Market Factors***

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

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

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

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**Service Costs**

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

user acquisition costs;

amortization and impairment of intangible assets;

license and content fees;

credit card processing fees;

network operations;

serving our search results;

maintaining our Web sites;

domain name registration renewal fees;

network fees;

fees paid to outside service providers;

delivering customer service;

depreciation of our Web sites, network equipment and internally developed software;

colocation service charges of our Web site equipment;

bandwidth and software license fees;

salaries of related personnel; and

stock-based compensation of related personnel.

***User Acquisition Costs***

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

These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that 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 that may be paid in advance.

We expense user acquisition costs based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed 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 expensed as incurred based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.



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### **Sales and Marketing**

Sales and marketing expenses consist primarily of:

payroll and related expenses for personnel engaged in marketing and sales functions;

advertising and promotional expenditures including online and outside marketing activities;

cost of systems used to sell to and serve merchant advertisers; and

stock-based compensation of related personnel.

### **Product Development**

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

Our research and development expenses include:

compensation and related expenses;

costs of computer hardware and software;

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

stock-based compensation of related personnel.

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

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

### **General and Administrative**

General and administrative expenses consist primarily of:

payroll and related expenses for executive and administrative personnel;

professional services, including accounting, legal and insurance;

bad debt provisions;

facilities costs;

other general corporate expenses; and

stock-based compensation of related personnel.

**Stock-Based Compensation**

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

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

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

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Stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations in accordance with SAB 107.

### **Amortization of Intangibles from Acquisitions**

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

The intangible assets have been identified as:

non-competition agreements;

trade and Internet domain names;

distributor relationships;

merchant advertising customer base relationships; and

acquired technology.

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

### **Provision for Income Taxes**

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

As of March 31, 2007, we had federal 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 federal NOL carryforwards will never be utilized.

As of March 31, 2007, we had certain tax effected state net operating loss carryforwards of approximately \$1.2 million. We do not have a history of taxable income in the relevant state and the state net operating loss carryforwards will more likely than not expire unutilized. Therefore, we have recorded a 100% valuation allowance on the state net operating loss carryforwards as of March 31, 2007.



**Table of Contents****Follow-on Public Offering**

In February 2005, we closed a follow-on public offering of 9,200,000 shares of Class B common stock at a public offering price of \$20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of \$250 per share and with a liquidation preference of \$250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of \$12.2 million, were approximately \$174.1 million and \$55.3 million, respectively, for an aggregate amount of \$229.4 million. All of the net proceeds have been used to fund the Name Development and Pike Street Industries asset acquisitions, and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006, and for working capital and other general corporate purposes.

Holders of the preferred stock are entitled to receive cumulative dividends from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15<sup>th</sup> 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.

The Company's board of directors declared the following quarterly dividends in 2006 and 2007 on the Company's 4.75% convertible exchangeable preferred stock:

Approval Date	Per share	Date of record	Total amount	
	dividend		(in thousands)	Payment date
January 2006	2.97	February 4, 2006	662	February 15, 2006
April 2006	2.97	May 4, 2006	422	May 15, 2006
July 2006	2.97	August 4, 2006	422	August 15, 2006
October 2006	2.97	November 4, 2006	422	November 15, 2006
January 2007	2.97	February 2, 2007	21	February 15, 2007

In April 2007, the Company's board of directors declared a quarterly dividend in the amount of \$2.97 per share on its 4.75% convertible exchangeable preferred stock which will be paid on May 15, 2007 to the holders of record as of the close of business on May 4, 2007. This quarterly dividend totals approximately \$21,000.

The preferred stock is convertible at the option of the holder at any time into shares of Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of \$24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change. During 2005, 4,515 shares of preferred stock were converted at the option of the holders into 46,071 shares of the Company's Class B common stock at a conversion price of \$24.50 per share. In January 2006, 2,500 shares of preferred stock were converted at the option of the holders into 25,510 shares of the Company's Class B common stock at a conversion price of \$24.50 per share. In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted 80,848 shares of the Company's preferred stock into 824,980 shares of the Company's Class B common stock at a conversion rate of \$24.50 per share and received a cash payment from the Company of \$12.00 per share of preferred stock for an aggregate amount of approximately \$970,000 in order to induce conversions. The \$970,000 was reflected as preferred stock dividends and conversion payment in the Company's financial statements. In December 2006, the Company repurchased an aggregate of 132,379 shares of preferred stock outstanding at a price of \$195.00 per share (plus commissions), representing a total cash expenditure of approximately \$26.0 million. In February 2007, the Company repurchased an additional 2,825 shares of preferred stock for a total cash expenditure of \$555,000. Approximately 6,933 shares of preferred stock remain outstanding at March 31, 2007.

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.

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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 March 31, 2007. The Debentures, if issued, will mature 25 years after the exchange date.

**Results of Operations**

The following table presents certain financial data, derived from our unaudited statements of operations, as a percentage of total revenue for the periods indicated. The operating results for the three months ended March 31, 2006 and 2007 and are not necessarily indicative of the results that may be expected for the full year or any future period.

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2007</b>
Revenue	100.0%	100.0%
Expenses:		
Service costs	47.7%	44.5%
Sales and marketing	18.9%	21.9%
Product development	7.2%	7.6%
General and administrative	11.0%	12.2%
Amortization of acquired intangible assets	15.7%	13.2%
Total operating expenses	100.4%	99.5%
Gain (loss) on sales and disposals of intangible assets, net	0.6%	0.1%
Income from operations	0.2%	0.6%
Other income (expense):		
Interest income	2.4%	2.1%
Interest expense	0.0%	0.0%
Other	0.0%	0.0%
Total other income	2.4%	2.1%
Income before provision for income taxes	2.6%	2.7%
Income tax expense	2.1%	1.4%
Income before cumulative effect of a change in accounting change	0.5%	1.3%
Cumulative effect of change in accounting principle	0.5%	0.0%
Net income	1.0%	1.3%
Convertible preferred stock dividend, conversion payment, and discount on preferred stock redemption	4.8%	(0.3%)

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Net income (loss) applicable to common stockholders

(3.8%)

1.6%

**Table of Contents****Comparison of the Three Months ended March 31, 2006 to the Three Months ended March 31, 2007****Revenue**

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

	Three months ended March 31,	
	2006	2007
Proprietary Traffic Sources	\$ 11,301,167	\$ 15,115,924
Partner and Other Revenue Sources	19,811,158	19,107,477
<b>Total Revenue</b>	<b>\$ 31,112,325</b>	<b>\$ 34,223,401</b>

Our proprietary traffic revenues are generated from our proprietary network of Web sites which are monetized with pay-per-click and cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of our owned and operated Web sites and clicks on a particular listing or completes the specified action, we receive a fee. Our partner network revenues are primarily generated using third-party distribution networks to deliver the merchant advertisers' listings. The distribution network includes search engines, shopping engines, directories, destination sites, third-party Internet domains or Web sites, and other targeted Web-based content. We generate revenue upon delivery of qualified and reported click-throughs to our merchant advertisers or to advertising services providers' listings. We pay a revenue share to the distribution partners to access their online user traffic. Other revenues include our bid management services, natural search optimization services and outsourced search marketing platforms.

Revenue increased 10%, from \$31.1 million for the three months ended March 31, 2006 to \$34.2 million in the same period in 2007. Our proprietary traffic revenues were the principal reason for the increase which are attributable to our portfolio of more than 200,000 Web sites. The majority of the revenues from our proprietary traffic are attributable to the Name Development and Pike Street asset acquisitions in 2005 and the AreaConnect asset acquisitions in 2006 including their respective portfolios of Web sites. We believe the increase in proprietary revenues is in part attributable to updates and enhancements for certain of the Web sites as well as increased sales, marketing and optimization efforts and expenditures.

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, including our existing agreement with Yahoo! which terminates, if not renewed, in the latter part of 2007, or replace traffic lost from terminated distribution agreements with other sources or if our distribution partners' search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our ability to maintain and grow our revenues will also depend in part on maintaining and growing our proprietary traffic sources and also maintaining and increasing the number and volume of transactions and favorable variable payment terms with merchant advertisers and advertising services providers, which we believe is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers and advertising services providers.

**Expenses**

Expenses were as follows:

	Three months ended March 31,			
	2006	% of revenue	2007	% of revenue
Service costs	14,851,949	48%	15,241,228	45%
Sales and marketing	5,866,684	19%	7,509,921	22%
Product development	2,227,024	7%	2,597,656	8%
General and administrative	3,409,508	11%	4,180,775	12%
Amortization of acquired intangible assets	4,870,673	16%	4,523,134	13%





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Effective January 1, 2006, we adopted SFAS 123R and record stock-based compensation expense under the fair value method. In the three months ended March 31, 2007, we recorded \$2.9 million of stock-based compensation expense compared to \$3.5 million for the same period in 2006. This stock-based compensation expense has been included in the same lines as compensation paid to the same individuals in the consolidated statement of operations in accordance with SAB 107.

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

	Three months ended March 31,	
	2006	2007
Service costs	\$ 236,211	\$ 118,535
Sales and marketing	1,047,271	372,358
Product development	735,187	489,252
General and administrative	1,502,074	1,907,069
<b>Total stock-based compensation</b>	<b>\$ 3,520,743</b>	<b>\$ 2,887,214</b>

See Note 3 Stock-based Compensation Plans of the condensed consolidated statements as well as our Critical Accounting Policies for additional information about stock-based compensation.

*Service Costs.* Service costs increased 3% from \$14.9 million in the three months ended March 31, 2006 to \$15.2 million in the same period in 2007. The increase was primarily attributable to an increase in facility and other costs of \$299,000, and an increase in registration fees and Internet domain amortization of \$89,000.

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 48% of revenue in the three months ended March 31, 2006 as compared to 45% in 2007. The 2007 decrease as a percentage of revenue in service costs as compared to the same period in 2006 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. We expect that user acquisition costs and revenue shares to distribution partners are likely to increase prospectively given the competitive landscape for distribution partners. To the extent that payments to feed management and pay-per-click services distribution partners make up a larger percentage of future operations, or the addition or renewal of existing distribution partner agreements are on terms less favorable to us, we expect that service costs will increase as a percentage of revenue. Our proprietary traffic sources have a lower service cost as a percentage of revenue relative to our overall service cost percentage. To the extent our proprietary traffic sources make up a larger percentage of our future operations, we expect that service costs will decrease as a percentage of revenue. We also expect that service costs will continue to increase in absolute dollars as a result of costs associated with the expansion of our operations and additional stock-based compensation expense due to our adoption of SFAS 123R in 2006.

*Sales and Marketing.* Sales and marketing expenses increased 28%, from \$5.9 million for the three months ended March 31, 2006 to \$7.5 million in the same period in 2007. As a percentage of revenue, sales and marketing expenses were 19% and 22% for the three months ended March 31, 2006 and 2007, respectively. The increase in dollars was related primarily to an increase in online and outside marketing and customer acquisition activities. 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 and as a result of additional stock-based compensation expense due to our adoption of SFAS 123R.

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*Product Development.* Product development expenses increased 17%, from \$2.2 million in the three months ended March 31, 2006 to \$2.6 million in the same period in 2007. As a percentage of revenue, product development expenses were 7% and 8% for the three months ended March 31, 2006 and 2007, respectively. The increase in dollars was primarily due to an increase in personnel costs of \$308,000 primarily related to an increase in the number of employees, and an increase in depreciation expense and other operating costs of \$63,000. 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 and as a result of additional stock-based compensation expense due to our adoption of SFAS 123R.

*General and Administrative.* General and administrative expenses increased 23%, from \$3.4 million in the three months ended March 31, 2006 to \$4.2 million in the same period in 2007. The increase in dollars was primarily due to an increase in personnel costs of \$651,000 of which \$405,000 was related to stock-based compensation, an increase in professional services of \$78,000, and an increase in facilities and other costs of \$42,000. As a percentage of revenue, general and administrative expenses were 11% and 12% for the three months ended March 31, 2006 and 2007, respectively. As a percentage of revenue, the increase in general and administrative expenses in 2007 as compared to 2006 was primarily a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006. We expect that our general and administrative expenses will increase in absolute dollars as a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006 and to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance.

*Amortization of Intangible Assets From Acquisitions.* Intangible amortization expense decreased 7%, from \$4.9 million in the three months ended March 31, 2006 to \$4.5 million in the same period in 2007. The decrease was associated with certain intangible assets from acquisitions being fully amortized in 2006. During the three months ended March 31, 2007, the components of amortization of intangibles were service costs of \$3.2 million, sales and marketing of \$715,000 and general and administrative of \$585,000.

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 \$81.5 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.

*Gain (loss) on sales and disposals of intangible assets, net.* The gain (loss) on sales and disposals of intangible assets, net was \$179,000 for the three months ended March 31, 2006 as compared to \$32,000 in the same period in 2007 and was attributable to the sales and disposals of Internet domain name intangible assets.

*Other Income.* Other income decreased 3%, from \$734,000 in the three months ended March 31, 2006 to \$712,000 in the same period in 2007. The decrease was primarily attributable to a decrease in interest income.

*Income Taxes.* The income tax expense in the three months ended March 31, 2006 was \$654,000 as compared to \$474,000 in the same period in 2007.

In the three months ended March 31, 2006, the effective tax rate of 82% differed from the expected effective tax rate of 35% primarily due to state income taxes, non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method as prescribed by SFAS 123R and other amounts. The effective tax rate of 52% in the three months ended March 31, 2007, differed from the expected tax rate of 35% due to state income taxes, non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method as prescribed by SFAS 123R, and other amounts.

During the three months ended March 31, 2006 and 2007, as a result of tax deductions from stock option exercises, we recognized tax-effected benefits of approximately \$1.5 million and \$1.8 million, respectively, which were recorded as credits to additional paid in capital.

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*Cumulative effect of Change in Accounting Principle.* For the three months ended March 31, 2006, a one-time gain of \$151,000, net of tax, was recognized as an cumulative effect of a change in accounting principle based on SFAS 123R's requirement to apply an estimated forfeiture rate to unvested awards. Previously, forfeitures had been recorded as incurred.

*Convertible Preferred Stock Dividends, Conversion Payment, and Discount on Preferred Stock Redemption, net.* The convertible preferred stock dividends decreased 107%, from \$1.5 million in the three months ended March 31, 2006 to (\$107,000) in the same period in 2007. In the three months ended March 31, 2006, there was a one time payment of \$970,000 associated with the voluntary conversion of approximately 80,848 shares in March 2006 and \$524,000 of preferred dividends based on an outstanding balance of 142,137 shares. In the same period in 2007, preferred dividends were \$16,000 based on an outstanding balance of 6,933 shares, net of a \$123,000 discount on preferred stock redemption in connection with our repurchase of an aggregate of 2,825 shares of preferred stock outstanding at a price of \$195.00 per share (plus commissions). Preferred stock dividends are based upon a dividend rate of 4.75%.

*Net Income (Loss) Applicable to Common Stockholders.* Net income (loss) applicable to common stockholders increased from a net loss of \$1.2 million for the three months ended March 31, 2006 to a net income of \$548,000 in the same period in 2007. The increase was primarily attributable to a decrease in convertible stock dividends, conversion payment and discount on preferred stock redemption, net of \$1.6 million and a decrease in stock based compensation of \$634,000.

**Liquidity and Capital Resources**

As of March 31, 2007, we had cash and cash equivalents of \$59.1 million. As of March 31, 2007, we had contractual obligations of \$5.3 million of which \$3.6 million is for rent under our facility leases.

Cash provided by operating activities primarily consists of net income adjusted for certain non-cash items such as depreciation and amortization, deferred income taxes, excess tax benefit related to stock options, and changes in working capital. Cash provided by operating activities for the three months ended March 31, 2007 of approximately \$12.5 million consisted primarily of net income of \$441,000 adjusted for non-cash items of \$6.4 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes, and excess tax benefit related to stock options and approximately \$5.6 million provided by working capital, other activities and for decreases in restricted cash. Cash provided by operating activities for the three months ended March 31, 2006 of approximately \$9.4 million consisted primarily of net income of \$298,000 adjusted for non-cash items of \$9.0 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes and cumulative effect of a change in accounting principle and approximately \$153,000 provided 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 three months ended March 31, 2006 and 2007. In certain cases, payments to distribution partners are paid in advance or are fixed in advance based on a guaranteed minimum amount of usage delivered.

Nearly all of the feed management services and advertising services provider arrangements are billed on a monthly basis following the month of our click-through delivery. This payment structure results in our advancement of monies to the distribution partners who have provided the corresponding placements of the

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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 three months ended March 31, 2007 of approximately \$1.5 million was primarily attributable to net purchases for property and equipment of \$1.6 million and purchases for Internet domain names or Web sites of approximately \$94,000, offset by proceeds from the sales of intangible assets of approximately \$155,000. Cash used in investing activities for the three months ended March 31, 2006 of approximately \$815,000 was primarily attributable to purchases for Internet domain names or Web sites of approximately \$254,000, net purchases for property and equipment of \$1.5 million, offset by proceeds of \$614,000 from the sales of intangible assets and proceeds of approximately \$400,000 from the settlement of certain intangible asset indemnification obligations in connection with our acquisitions.

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 three months ended March 31, 2007 of approximately \$2.0 million was primarily attributable to net proceeds of approximately \$1.9 million from the sale of stock through employee stock options and employee stock purchases and \$1.5 million of excess tax benefit related to stock options offset by preferred and common stock dividend payments of \$21,000 and \$832,000, respectively, and the repurchase of 2,825 shares of preferred stock outstanding at a price of \$195.00 per share (plus commissions) totaling approximately \$555,000. Cash provided by financing activities for the three months ended March 31, 2006 of approximately \$819,000 was primarily attributable to net proceeds of approximately \$976,000 from the sale of stock through employee stock options and employee stock purchases and \$1.5 million of income tax benefit related to stock options offset by preferred dividend payments of \$1.6 million which included the one-time payment of \$970,000 associated with the voluntary conversion of approximately 80,848 shares of our preferred stock into approximately 824,980 shares of our Class B common stock.

The following table summarizes our contractual obligations as of March 31, 2007, 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
<b>Contractual Obligations:</b>				
Operating leases	\$ 3,624,621	\$ 1,047,848	\$ 2,407,479	\$ 169,294
Capital leases	58,768	16,878	41,890	
Other contractual obligations	1,569,955	1,003,465	566,490	
<b>Total contractual obligations (1), (2)</b>	<b>\$ 5,253,344</b>	<b>\$ 2,068,191</b>	<b>\$ 3,015,859</b>	<b>\$ 169,294</b>

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

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(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.

During the three months ended March 31, 2007, we paid approximately \$94,000 for the purchase of additional Internet domains. We expect to continue acquiring Internet domains or Web sites in the normal course of business as we grow our proprietary network of Web sites.

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

We will have an annual dividend payment obligation under the terms of the preferred stock of \$82,000 based upon approximately 6,933 convertible preferred shares outstanding as of March 31, 2007. Dividends are cumulative and payable quarterly on the 15<sup>th</sup> 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, to make payments of principal and interest under the debentures and to pay dividends on our common stock in the future will depend on our financial results, liquidity and financial condition.

In November 2006, our Board of Directors authorized a share repurchase program to repurchase up to 3 million shares of our Class B common stock as well as the initiation of a quarterly cash dividend for the holders of the Class A common stock and Class B common stock. Under the share repurchase program, repurchases may take place in the open market and in privately negotiated transactions and at times and in such amounts as we deem appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice. No common shares were repurchased during the quarter.

The quarterly cash dividend was initiated at \$0.02 per share of Class A common stock and Class B common stock. Quarterly dividends were paid on February 15, 2007 to Class A and Class B common stockholders of record as of the close of business on February 2, 2007. The aggregate quarterly dividend paid was approximately \$832,000.

In April 2007, our Board of Directors declared a regular quarterly dividend of \$0.02 per share on our Class A common stock and Class B common stock and \$2.97 per share on our 4.75% convertible exchangeable preferred stock. Marchex will pay these dividends on May 15, 2007 to the holders of record as of the close of business on May 4, 2007.

Although we expect that the annual cash dividend, subject to capital availability, will be \$0.08 per common share or approximately \$3.3 million for the foreseeable future, there can be no assurance that we will continue to pay dividends at such a rate or at all.

On July 7, 2005, a Registration Statement on Form S-3 (File No. 333-125372) relating to the resale of 1,382,093 shares of our Class B common stock by certain selling stockholders with S-3 or piggyback registration

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rights granted principally in connection with our prior acquisitions was declared effective by the SEC. We were 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 SEC. We are contractually required to use best efforts to keep this Registration Statement effective for a period of one year from the date the Registration Statement became effective (plus the period of time, if any, during which sales may be suspended while the suspension right is in effect). We will not receive any proceeds in connection with these sales by selling stockholders.

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

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

### **Critical Accounting Policies**

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

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

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

Revenue;

Goodwill and intangible assets;

Stock-based compensation; and

Allowance for doubtful accounts, merchant advertiser and incentive program credits.

#### ***Revenue***

We currently generate revenue through our operating businesses by delivering performance-based and search marketing services to merchant advertisers and advertising service providers. The primary revenue driver





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

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

***Goodwill and Intangible Assets***

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

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

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

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group. If such asset group is considered to be impaired, the impairment is to be recognized by the amount by which the carrying amount of the assets exceeds fair value. Assets to be disposed of are separately presented on the balance sheet and reported at the lower of their carrying amount or fair value less costs to sell, and are no longer depreciated.

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

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

***Stock-Based Compensation***

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

Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with FAS 123R, the assumptions used in calculating fair value of stock-based awards and the Black-Scholes option pricing model are highly subjective, and other reasonable assumptions could provide differing results. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience of our stock-based awards that are granted, exercised and cancelled. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 3 Stock-based Compensation Plans in the condensed consolidated financial statements for additional information.

***Allowance for Doubtful Accounts and Merchant Advertiser and Incentive Program Credits***

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

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

### **Recent Accounting Pronouncements**

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

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

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

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our exposure to market risk is limited to interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term, money market funds. We place our investments with high-quality financial institutions and limit the amount of credit exposure to any one financial institution. Due to the nature of our short-term investments, we believe that we are not subject to any material market risk exposure. We do not have any material foreign currency or other derivative financial instruments.

### **Item 4. Controls and Procedures**

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

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our chief executive officer and our chief financial officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based on this evaluation, our chief executive officer and our chief financial officer have concluded that, as of the date of the evaluation, our disclosure controls and procedures were effective.

#### **Changes in Internal Controls**

During the quarter ended March 31, 2007, no change was made to our internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**Limitations on the Effectiveness of Controls**

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can not provide absolute assurance of achieving the desired control objectives.

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

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### **Part II Other Information**

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

We have updated the risk factors previously disclosed in Part I, Item 1A, under the caption "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2006, which was filed with the SEC on March 16, 2007, as set forth below. We do not believe any of the changes constitute material changes to the risk factors.

An investment in our Class B common stock or preferred stock involves various risks, including those mentioned below and those that are discussed from time to time in our other periodic filings with the SEC. Investors should carefully consider these risks, along with the other information contained in this report, before making an investment decision regarding our stock. There may be additional risks of which we are currently unaware, or which we currently consider immaterial. All of these risks could have a material adverse effect on our financial condition, our results of operations, and the value of our stock.

#### **Risks Relating to Our Company**

##### **Our limited operating history makes evaluation of our business difficult.**

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

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

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

We had an accumulated deficit of \$5.7 million as of March 31, 2007. Our net expenses may increase based on the initiatives we undertake which for instance, may include increasing our sales and marketing activities, hiring additional personnel, incurring additional costs as a result of being a public company, and acquiring additional businesses. In addition, commencing January 1, 2006, we began expensing the fair value of stock options granted in connection with our adoption of the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment ( SFAS 123R ).

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

A relatively small number of distribution partners currently deliver a significant percentage of traffic to our merchant listings. Yahoo! Search Marketing is our largest distribution partner and delivers traffic to our merchant listings which collectively represents approximately 8% of our total revenue for the three months ended

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March 31, 2007. Separately, Yahoo! Search Marketing was responsible for 39% of our total revenue during the same period principally in respect of the revenues associated with our network of domains.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We are obligated to pay quarterly dividends to the holders of preferred stock at an annual rate of \$11.875 per preferred share. There are currently approximately 6,024 shares of preferred stock outstanding following the conversions into shares of Class B common stock or cash repurchases that have occurred to date.

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

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

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

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

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



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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;

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

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

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

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

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

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

Further, as of March 31, 2007, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister together controlled 88% of the combined voting power of our outstanding capital stock excluding shares of Class B common stock issuable upon conversion of preferred stock. Their collective voting control is not tied to their continued employment with Marchex. The loss of the services of any member of our senior management, including our founding executive officers, for any reason, or any conflict among our founding executive officers, could harm our current and future operations and prospects.

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

Our performance is largely dependent upon the talents and efforts of highly skilled individuals. In order to fully implement our business plan, we will need to retain our current qualified personnel, as well as attract and retain additional qualified personnel. Thus, our success will in significant part depend upon our retention of current personnel as well as the efforts of personnel not yet identified and upon our ability to attract and retain

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highly skilled managerial, engineering, sales and marketing personnel. We are also dependent on managerial and technical personnel to the extent they may have knowledge or information about our businesses and technical systems that may not be known by our other personnel. There can be no assurance that we will be able to attract and retain necessary personnel. The failure to hire and retain such personnel could adversely affect the implementation of our business plan.

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

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

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

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

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

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

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

Effective internal controls are necessary for us to provide reliable and accurate financial reports and effectively prevent fraud. We have devoted significant resources and time to comply with the new internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002. In addition, Section 404 under the Sarbanes-Oxley Act of 2002 requires that we assess and our auditors attest to the design and operating effectiveness of our controls over financial reporting. Our current and future compliance with the annual internal control report requirement will depend on the effectiveness of our financial reporting and data systems and controls across our operating subsidiaries. We expect these systems and controls to become increasingly complex

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to the extent that we integrate acquisitions and our business grows. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. We cannot be certain that these measures will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation or operation, could harm our operating results or cause us to fail to meet our financial reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock and our access to capital.

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

We adopted the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment ( SFAS 123R ) on January 1, 2006. Thus, our consolidated financial statements for 2006 and 2007 will reflect the fair value of stock options granted to employees as a compensation expense, which has had, and will in the future likely continue to have a significant adverse impact on our results of operations and net income per share. We rely heavily on stock options to compensate existing employees and to attract new employees. If we reduce or alter our use of stock-based compensation to minimize the recognition of these expenses, our ability to recruit, motivate and retain employees may be impaired, which could put us at a competitive disadvantage in the employee marketplace. In order to prevent any net decrease in their overall compensation packages, we may choose to make corresponding increases in the cash compensation or other incentives we pay to existing and new employees. Any increases in employee wages and salaries would diminish our cash available for marketing, product development and other uses and might cause our GAAP profits to decline. Any of these effects might cause the market price of our Class B common stock and preferred stock to decline.

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

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

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

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

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

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

A significant amount of revenue attributed to our domain name assets comes through our agreement with Yahoo! and its subsidiaries. Under our agreement, Yahoo! has certain limited exclusive and

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

In the ordinary course of business we have been subject to and in the future it is likely that we will continue to be subject to intellectual property infringement claims, including claims of trademark infringement with respect to Internet domain names acquired by us. As a result of these claims, we have lost and in the future it is likely that we will continue to lose domain names from which we derive revenue. We may not be able to recoup any resulting financial losses from the prior domain name owners.

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

Some of our existing distribution partners may perceive our proprietary network of Web sites as a competitive threat and therefore may decide to terminate their agreements with us.

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

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

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

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

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

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

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

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

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

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

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

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### **Risks Relating to Our Business and Our Industry**

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

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

sales to merchant advertisers of pay-per-click services;

sales to merchant advertisers of feed management services;

aggregation or optimization of online advertising for distribution through search engines, product shopping engines, directories, Web sites or other outlets;

delivery of online advertising to end users or customers of merchants through destination Web sites or other distribution outlets;

local search sales training;

services and outsourcing of technologies that allow merchants to manage their advertising campaigns across multiple networks and track the success of these campaigns; and

third party domain monetization.

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

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

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

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

longer operating histories;

more management experience;

an employee base with more extensive experience;

better geographic coverage;

larger customer bases;

greater brand recognition; and

significantly greater financial, marketing and other resources.



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

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

In addition to Internet companies, we face competition from companies that offer traditional media advertising opportunities. Most large advertisers have set advertising budgets, a very small portion of which is allocated to Internet advertising. We expect that large advertisers will continue to focus most of their advertising efforts on traditional media. If we fail to convince these companies to spend a portion of their advertising budgets with us, or if our existing advertisers reduce the amount they spend on our programs, our operating results would be harmed.

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

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

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

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

fire;

floods;

network failure;

hardware failure;

software failure;

power loss;

telecommunications failures;

break-ins;

terrorism, war or sabotage;

computer viruses;

denial of service attacks;

penetration of our network by unauthorized computer users and hackers and other similar events;

natural disaster; and

other unanticipated problems.

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

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

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

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

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

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

Despite our efforts to protect our proprietary rights, unauthorized parties domestically and internationally may attempt to copy or otherwise obtain and use our services, technology and other intellectual property. We

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cannot be certain that the steps we have taken will prevent any misappropriation or confusion among consumers and merchant advertisers. If we are unable to protect our intellectual property rights from unauthorized use, our competitive position could be adversely affected.

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

We may initiate patent litigation against third parties to protect or enforce our patent rights, and we may be similarly sued by others. We may also become subject to interference proceedings conducted in the patent and trademark offices of various countries to determine the priority of inventions. The defense and prosecution, if necessary, of intellectual property suits, interference proceedings and related legal and administrative proceedings is costly and may divert our technical and management personnel from their normal responsibilities. We may not prevail in any of these suits. An adverse determination of any litigation or defense proceedings could put our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not being issued.

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

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

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

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

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

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

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

possible disruptions or other damage to the Internet or telecommunications infrastructure;

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failure of the individual networking infrastructures of our merchant advertisers and distribution partners to alleviate potential overloading and delayed response times;

a decision by merchant advertisers and consumers to spend more of their marketing dollars on offline programs;

increased governmental regulation and taxation; and

actual or perceived lack of security or privacy protection.

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

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

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

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

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

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

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

the Children's Online Privacy Protection Act (COPPA) restricts the distribution of certain materials deemed harmful to children and impose limitations on the Web sites' ability to collect personal information from minors. COPPA allows the Federal Trade Commission (FTC) to impose fines and penalties upon Web site operators whose sites do not fully comply with the law's requirements. Another child protection law, the Child Online Protection Act (COPA), was intended to restrict the

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distribution of certain materials deemed harmful to children. This law was struck down as unconstitutional, but a similar federal or state law might be reintroduced in the future.

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

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

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

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

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

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

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

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

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

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

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

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

### **Risks Relating to Ownership of our Common Stock and Preferred Stock**

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

The trading prices of our Class B common stock and preferred stock have been and are likely to continue to be highly volatile and subject to wide fluctuations. Since our initial public offering, the closing sale price of our Class B common stock on the Nasdaq Global Market (formerly, the Nasdaq National Market) ranged from \$8.56 to \$26.14 per share through March 31, 2007. Since our February 2005 follow-on offering, the closing sale price of our preferred stock on the Nasdaq Global Market (formerly, the Nasdaq National Market) ranged from \$150.71 to \$267.00 per share through March 31, 2007. Our stock prices may fluctuate in response to a number of events and factors, which may be the result of our business strategy or events beyond our control, including:

developments concerning proprietary rights, including patents, by us or a competitor;

announcements by us or our competitors of significant contracts, acquisitions, financings, commercial relationships, joint ventures or capital commitments;

registration of additional shares of Class B common stock in connection with acquisitions;

actual or anticipated fluctuations in our operating results;

developments concerning our various strategic collaborations;

lawsuits initiated against us or lawsuits initiated by us;

announcements of acquisitions or technical innovations;

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



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changes in earnings estimates or recommendations by analysts;

changes in the market valuations of similar companies;

changes in our industry and the overall economic environment;

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

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

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

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

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

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

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

As of March 31, 2007, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, beneficially owned 96% of the outstanding shares of our Class A common stock, which shares represented 87% of the combined voting power of all outstanding shares of our capital stock. These founding executive officers together control 88% of the combined voting power of all outstanding shares of our capital stock excluding shares of Class B common stock issuable upon conversion of the preferred stock. The holders of our Class A common stock and Class B common stock have identical rights except that the holders of our Class B common stock are entitled to one vote per share, while holders of our Class A common stock are entitled to twenty-five votes per share on all matters to be voted on by stockholders. This concentration of control could be disadvantageous to our other stockholders with interests different from those of these founding executive officers. This difference in the voting rights of our Class A common stock and Class B common stock could adversely affect the price of our Class B common stock to the extent that investors or any potential future purchaser of our shares of Class B common stock give greater value to the superior voting rights of our Class A common stock.

Further, as long as these founding executive officers have a controlling interest, they will continue to be able to elect all or a majority of our board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, these founding executive officers will be in a position to continue to control all fundamental matters affecting our company, including any merger involving, sale of



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substantially all of the assets of, or change in control of, our company. The ability of these founding executive officers to control our company may result in our Class B common stock and preferred stock trading at a price lower than the price at which such stock would trade if these founding executive officers did not have a controlling interest in us. This control may deter or prevent a third party from acquiring us which could adversely affect the market price of our Class B common stock and preferred stock.

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

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

the authorized number of our directors can be changed only by a resolution of our board of directors;

advance notice is required for proposals that can be acted upon at stockholder meetings;

there are limitations on who may call stockholder meetings; and

our board of directors is authorized, without prior stockholder approval, to create and issue blank check preferred stock.

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

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

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

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

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

### **The market price of the preferred stock may decline.**

An active trading market for the preferred stock has not fully developed and as a result, the market price and liquidity of the preferred stock will be adversely affected. Even if an active trading market for the preferred stock were to develop, the preferred stock could trade for less than the public offering price, depending on many

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factors, including prevailing interest rates, our operating results and the markets for similar securities, and such active trading market could cease to continue at any time. In addition, if the preferred stock is exchanged for debentures, we are not obligated to list the debentures and cannot assure you that a market for the debentures will develop.

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

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

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

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

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

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

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

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

We issued the following securities, none of which have been registered under the Securities Act of 1933, as amended (the Act ) during the first quarter of 2007:

1. On January 1, 2007, the Company issued 2.3 million shares of restricted stock to certain executives under the Company's 2003 amended and restated stock incentive plan, with a weighted average exercise price of \$13.38 per share. The issuance of such restricted shares was not registered under the Securities Act of 1933. No underwriters were involved in the issuance of restricted shares. The issuance of restricted shares was 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.

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During the first quarter of 2007, share repurchase activity was as follows:

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares (or approximate dollar value) that may yet be purchased under the plans or programs (2)
<b>Class B Common Shares:</b>				
January 1, 2007 - January 31, 2007	53,094(1)	\$ 0.01		
February 1, 2007 - February 28, 2007	808(1)	\$ 0.01		
March 1, 2007 - March 31, 2007 (3)				
<b>Total Class B Common Shares</b>	<b>53,902</b>	<b>\$ 0.01</b>		<b>3,000,000</b>
Total Preferred Shares	2,825(4)	\$195 (plus commission)		

- (1) All shares were shares of restricted equity subject to vesting which were issued to employees in connection with certain of our acquisitions. We repurchased the shares above which were not already vested from certain of our employees upon their termination of employment.
- (2) On November 15, 2006, we announced that our Board of Directors authorized a share repurchase program to repurchase up to 3 million shares of our Class B common stock through open market and privately negotiated transactions, at times and in such amounts as we deem appropriate. No shares will be knowingly purchased from company insiders or their affiliates. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be limited or terminated at any time without prior notice. No repurchases have been made under this program to date.
- (3) An aggregate of 250,000 shares of Class B stock were returned by the seller to the Company in satisfaction of certain intangible asset indemnification obligations in connection with the Name Development asset acquisition.
- (4) The preferred shares were repurchased in January 2007 pursuant to privately negotiated transactions.

**Item 6. Exhibits****Exhibits:**

- 31(i) Certification of CEO pursuant to Rule 13a-14(a)/15d-14(a).
- 31(ii) Certification of CFO pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of CEO pursuant to Section 1350.
- 32.2 Certification of CFO pursuant to Section 1350.

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**SIGNATURE**

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

**MARCHEX, INC.**

By: /s/ MICHAEL A. ARENDS  
Name: **Michael A. Arends**  
Title: **Chief Financial Officer**

**(Principal Accounting Officer)**

May 10, 2007