ZILLOW INC
Form 10-Q
November 04, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

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

Commission File Number: 001-35237

ZILLOW, INC.

(Exact name of registrant as specified in its charter)

Washington	**20-2000033**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**
1301 Second Avenue, Floor 31, Seattle, Washington	**98101**
(Address of principal executive offices)	**(Zip Code)**

(206) 470-7000

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

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

ZILLOW, INC.

Quarterly Report on Form 10-Q

For the Three Months Ended September 30, 2011

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

NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

ZILLOW, INC.

CONDENSED BALANCE SHEETS

(in thousands, except share data, unaudited)

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

Class C nonvoting common stock, $0.0001 par value; no shares and 50,000,000 shares authorized as of September 30, 2011 and December 31, 2010, respectively; no shares and 2,305,980 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively		
Additional paid-in capital	176,195	96,152
Accumulated other comprehensive loss	(78,531)	(78,709)
Total shareholders equity	97,667	17,448
Total liabilities and shareholders equity	$ 113,922	$ 24,013

See accompanying notes to condensed financial statements.

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ZILLOW, INC.

CONDENSED STATEMENTS OF OPERATIONS

(in thousands, except per share data, unaudited)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Revenues	$ 19,057	$ 8,229	$ 46,162	$ 20,894
Costs and expenses:				
Cost of revenues (exclusive of amortization) (1)	3,084	1,263	7,614	3,647
Sales and marketing	7,035	4,060	18,150	10,925
Technology and development	3,849	2,528	10,148	7,940
General and administrative (2)	5,695	1,902	10,151	4,726
Total costs and expenses	19,663	9,753	46,063	27,238
Income (loss) from operations	(606)	(1,524)	99	(6,344)
Other income	36	14	79	56
Net income (loss)	$ (570)	$ (1,510)	$ 178	$ (6,288)
Net income (loss) attributable to common shareholders	$ (570)	$ (1,510)	$ 178	$ (6,288)
Net income (loss) per share attributable to common shareholders basic	$ (0.02)	$ (0.12)	$ 0.01	$ (0.50)
Net income (loss) per share attributable to common shareholders diluted	$ (0.02)	$ (0.12)	$ 0.01	$ (0.50)
Weighted-average shares outstanding basic	24,020	12,803	17,141	12,702
Weighted-average shares outstanding diluted	24,020	12,803	20,220	12,702
(1) Amortization of website development costs and intangible assets included in technology and development is as follows:	$ 1,461	$ 1,030	$ 3,918	$ 3,107
(2) General and administrative includes a facility exit charge as follows:	$ 1,737	$	$ 1,737	$

See accompanying notes to condensed financial statements.

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ZILLOW, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

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

See accompanying notes to condensed financial statements.

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ZILLOW, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(unaudited)

Note 1. Organization and Description of Business

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

Certain Significant Risks and Uncertainties

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

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

Use of Estimates

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

Reverse Stock Split

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

Reclassifications

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

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Recently Issued Accounting Standards

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

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

Note 3. Fair Value Measurements

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

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

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

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

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

Assets

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

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

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

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

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

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

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Note 4. Accounts Receivable, net

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

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

Note 5. Property and Equipment, net

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

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

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

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

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

Note 6. Intangible Assets

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

	September 30, 2011	December 31, 2010

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

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

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Note 7. Income Taxes

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

Note 8. Shareholders Equity

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

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

Common Stock

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

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

Note 9. Share-Based Awards

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Note 11. Commitments and Contingencies

Lease Commitments

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

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

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

Purchase Commitments

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

2011	$ 322
2012	839
2013	520
2014	520
2015	520
All future years	130
Total future purchase commitments	$ 2,851

Line of Credit

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

Legal Proceedings

In October 2009, Mortgage Grader LLC filed a complaint against us for patent infringement in the Eastern District of Texas. The complaint alleged, among other things, that our website technology infringes one patent owned by Mortgage Grader, and sought injunctive relief, monetary damages, costs and attorneys fees. We denied Mortgage Grader s allegations and asserted counterclaims seeking declarations that we were not infringing the Mortgage Grader patent, and that the Mortgage Grader patent was unenforceable and invalid. In April 2010, Zillow and Mortgage Grader signed a patent license and settlement agreement for an insubstantial payment.

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

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

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

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

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

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

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

Note 12. Segment Information and Revenues

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

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

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

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

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Note 13. Subsequent Events

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

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

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

Overview

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

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

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

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

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

Key Growth Drivers

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

Unique Users

Measuring unique users is important to us because our marketplace revenues depend in part on our ability to enable our users to connect with real estate and mortgage professionals, and our display revenues depend in part on the number of impressions delivered. Furthermore, our community of users improves the quality of our living database of homes with their contributions. We measure unique users with Omniture analytical tools. Zillow counts a unique user the first time an individual accesses either Zillow.com or Postlets.com using a web browser during a calendar month, and the first time an individual accesses Zillow s mobile applications using a mobile device during a calendar month. If an individual accesses Zillow s websites using different web browsers within a given month, the first access by each such web browser is counted as a separate unique user. If an individual accesses both Zillow.com and Postlets.com in a single month, the first access to each website is counted as a separate unique user since unique users are tracked separately for each domain. If an individual accesses Zillow s mobile applications using different mobile devices within a given month, the first instance of access by each such mobile device is counted as a separate unique user.

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

Premier Agent Subscribers

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

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

Basis of Presentation

Revenues

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

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

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

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

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

Costs and Expenses

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

Sales and Marketing. Sales and marketing expenses consist of headcount expenses, including salaries, commissions, benefits, share-based compensation expense and bonuses for sales, sales support, customer support, marketing and public relations employees. Sales and marketing expenses also include other sales expenses related to promotional and marketing activities and facilities costs allocated on a headcount basis.

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

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

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

Income Taxes

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

Results of Operations

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

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

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	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(in thousands, unaudited)			
(1) Includes share-based compensation as follows:				
Cost of revenues	$ 48	$ 61	$ 134	$ 168
Sales and marketing	85	117	259	332
Technology and development	135	102	311	303
General and administrative	220	188	587	506
Total	$ 488	$ 468	$ 1,291	$ 1,309
(2) Amortization of website development costs and intangible assets included in technology and development is as follows:	$ 1,461	$ 1,030	$ 3,918	$ 3,107
(3) General and administrative includes a facility exit charge as follows:	$ 1,737	$	$ 1,737	$

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

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

Adjusted EBITDA

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

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

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

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

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

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

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

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

Adjusted EBITDA does not reflect certain facility exit charges.

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

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

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

Three Months Ended September 30, 2011 and 2010

Revenues

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

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

Total	100%	100%

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

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

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

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Cost of Revenues

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

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

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

Sales and Marketing

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

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

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

Technology and Development

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

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

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

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

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General and Administrative

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

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

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

Nine Months Ended September 30, 2011 and 2010

Revenues

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

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

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

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

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

Cost of Revenues

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

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

Sales and Marketing

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

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

Technology and Development

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

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

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

General and Administrative

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

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

Liquidity and Capital Resources

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

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

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

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

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

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

Cash Flows Provided By Operating Activities

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

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

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

Cash Flows Provided By (Used In) Investing Activities

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

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

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

Cash Flows Provided By Financing Activities

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

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

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

Off-Balance Sheet Arrangements

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

Contractual Obligations

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

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

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

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

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

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

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

Allowance for Doubtful Accounts

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

Website and Software Development Costs

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

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

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

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

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Share-Based Compensation

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

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

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

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

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

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

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

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

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

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

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

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

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

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Item 1A. Risk Factors

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

Risks Related to Our Business

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

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

- product development;
- sales and marketing;
- our technology infrastructure;
- strategic opportunities, including commercial relationships and acquisitions; and
- general administration, including legal and accounting expenses related to being a public company.

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

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

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

- increasing the number of consumers of our products and services;
- competing effectively for advertising dollars with other online media companies;
- continuing to develop our advertising products and services;
- keeping pace with changes in technology and with our competitors; and

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

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

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

Our success depends on our continued innovation to provide products and services that make our website and mobile applications useful for consumers and real estate and mortgage professionals and attractive to our advertisers. As a result, we must continually invest significant resources in research and development in order to improve the attractiveness and comprehensiveness of our products and services and effectively incorporate new Internet and mobile technologies into them. If we are unable to provide products and services that users, including real estate professionals, want to use, then users may become dissatisfied and use competitors websites and mobile applications. If we are unable to continue offering innovative products and services, we may be unable to attract additional users and advertisers or retain our current users and advertisers, which could harm our business, results of operations and financial condition.

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

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

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

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

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

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

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

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

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

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

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

condition.

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

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

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

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

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

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

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

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

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

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

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

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

Any significant disruption in Roman" style="font-size:8.0pt;">634

7.23

%

$

750

7.74

%

$

13,924

6.21

%

Total

$

19,106

$

39,640

$

2,787

$

925

$

62,458

Average Yield (TE)(2)

4.26

%

4.86

%

5.37

%

7.55

%

4.74

%

Non-marketable equity securities(3):
Federal Home Loan Bank stock

$

$

$

$

$

10,656

Other equity investments

$

$

$

$

$

3,191

Total

$

$

$

$

$

13,847

(1) Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and certain securities require principal repayments prior to maturity.

(2) Rate has been tax equivalized on state and municipal tax exempt securities.

(3) Due to the nature of these securities, they do not have a stated maturity date or rate.

Continuous gross unrealized losses of investments in debt and equity securities (in thousands) which are classified as temporary were as follows:

	Continuous unrealized losses existing for less than 12 months		Continuous unrealized losses existing greater than 12 months		Total	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
Available-for-Sale:						
Federal agencies	$ 23,372	$ 35	$ 257,999	$ 1,413	$ 281,371	$ 1,448
Mortgage-backed securities	2,850	14	6,241	206	9,091	220
State and municipal			1,596	32	1,596	32
Subtotal, debt securities	$ 26,222	$ 49	$ 265,836	$ 1,651	$ 292,058	$ 1,700
Marketable equity securities	$ 106	$ 31	$	$	106	31
Total temporarily impaired securities	$ 26,328	$ 80	$ 265,836	$ 1,651	$ 292,164	$ 1,731
Held-to-Maturity:						
Federal agencies	$	$	$ 20,645	$ 429	$ 20,645	$ 429
Mortgage-backed securities	1,539	8	21,835	293	23,374	301
State and municipal	956	2	3,015	26	3,971	28
Total temporarily impaired securities	$ 2,495	$ 10	$ 45,495	$ 748	$ 47,990	$ 758

Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for the period of time sufficient to allow for any anticipated recovery in fair value. Effective for the period ended December 31, 2005, the Company modified its policy for evaluating investments for other-than-temporary impairment. Under its new policy, investments, other than debt security investments where the impairment is deemed to be due solely to interest rate movements, are assumed to be impaired and the impairment recognized through earnings no later than twelve months from the date the security was first impaired, unless there is overwhelming evidence to the contrary. Under the policy, overwhelming evidence to the contrary is a rare instance, but might include, among other things, an announced sale soon after a reporting period where the price would cause an impairment to reverse. Further, under certain circumstances, including a bankruptcy, catastrophic event or other circumstances which cause the Company to determine, after analyzing the specific facts, that the decline in the fair value is other than temporary, the Company would recognize an other than temporary impairment write-down upon such occurrence or determination, and not wait twelve months from the time of the impairment.

For the period ended March 31, 2007, the $1.651 million continuous unrealized losses greater than 12 months on available-for-sale securities were made up of 52 debt securities and were believed to be temporary losses. Marketable equity securities available-for-sale have no continuous unrealized loss greater than 12 months. The $748,000 continuous unrealized losses greater than 12 months on held-to-maturity securities were made up of 43 debt securities and were believed to be temporary losses.

Unrealized losses on debt securities are generally due to changes in interest rates and, as such, are considered by the Company to be temporary. Because of the nature of U.S. Agency securities, most of which are single pay at maturity, and because the Company has the ability to hold these investments until the market value recovers, which may be maturity, the Company does not consider these investments to be other than temporarily impaired. Because the Company believes the decline in market value of mortgage-backed securities is attributable to changes in interest rates and not credit quality and because the Company has the ability to hold these investments until the market value recovers, the Company does not consider these investments to be other than temporarily impaired.

Loans

The following table presents the amounts and percentages of loans at March 31, 2007 and December 31, 2006 according to the categories of commercial, financial and agricultural; commercial real estate; residential real estate; and installment and consumer loans.

Amount of Loans Outstanding

(dollars in thousands)

	March 31, 2007 Amount	Percentage	December 31, 2006 Amount	Percentage
Commercial, financial and agricultural	$ 321,754	31.89 %	$ 312,873	31.23 %
Real Estate - Commercial	489,913	48.55 %	484,003	48.31 %
Real Estate - Residential	122,911	12.18 %	127,200	12.69 %
Installment and consumer	74,506	7.38 %	77,846	7.77 %
Total loans	$ 1,009,084	100.00 %	$ 1,001,922	100.00 %

The balance of loans outstanding as of March 31, 2007 by maturity is shown in the following table:

Maturity of Loans Outstanding

(dollars in thousands)

March 31, 2007

	1 year or less	1 to 5 years	Over 5 years	Total
Commercial, financial and agricultural	$ 179,929	$ 100,968	$ 40,857	$ 321,754
Real Estate - Commercial	129,284	240,635	119,994	489,913
Real Estate - Residential	9,412	28,916	84,583	122,911
Installment and consumer	16,003	24,143	34,360	74,506
Total	$ 334,628	$ 394,662	$ 279,794	$ 1,009,084
Percentage of total loans outstanding	33.16 %	39.11 %	27.73 %	100.00 %

Capital

Total shareholders equity increased $3.152 million from December 31, 2006 to March 31, 2007. Treasury stock transactions were $370,000 primarily due to the exercise of stock options. Additional paid in capital increased $205,000 due to current period stock option activity. The change in shareholders equity is summarized as follows:

Shareholders Equity (in thousands)

Shareholders equity, December 31, 2006	$ 150,355
Net income	4,774
Treasury stock transactions, net	370
Additional paid in capital	205
Cash dividends declared	(2,510)
Other comprehensive income	313
Shareholders equity, March 31, 2007	$ 153,507

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On March 20, 2007, the Board of Directors of the Company declared a quarterly cash dividend of $0.25 per share of the Company s common stock. The dividend of $2.510 million was paid on April 20, 2007, to holders of record on April 1, 2007.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s and the Bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, banks must meet specific guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company s and the Bank s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of March 31, 2007, that the Company and the Bank exceeded all capital adequacy requirements to which they are subject.

As of March 31, 2007, the most recent notifications from primary regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, banks must maintain minimum total capital to risk-weighted assets, Tier I capital to risk-weighted assets, and Tier I capital to average assets ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank s categories.

The Company s and the Bank s actual capital amounts and ratios are presented in the following table (in thousands):

	Actual Amount	Ratio	For capital adequacy purposes: Amount	Ratio	To be well capitalized under prompt corrective action provisions: Amount	Ratio
As of March 31, 2007:						
Total capital (to risk-weighted assets) Consolidated	$ 145,014	12.7 %	$ 91,658	8.0 %	N/A	
Main Street Bank & Trust	$ 130,796	11.6 %	$ 90,546	8.0 %	$ 113,183	10.0 %
Tier I capital (to risk-weighted assets) Consolidated	$ 132,272	11.5 %	$ 45,829	4.0 %	N/A	
Main Street Bank & Trust	$ 117,115	10.3 %	$ 45,273	4.0 %	$ 67,910	6.0 %
Tier I capital (to average assets) Consolidated	$ 132,272	8.7 %	$ 60.526	4.0 %	N/A	
Main Street Bank & Trust	$ 117,115	7.8 %	$ 60,076	4.0 %	$ 75,095	5.0 %

<u>Interest Rate Sensitivity</u>

The concept of interest rate sensitivity attempts to gauge exposure of the Company s net interest income to adverse changes in market driven interest rates by measuring the amount of interest-sensitive assets and interest-sensitive liabilities maturing or subject to repricing within a specified time period. Liquidity represents the ability of the

Company to meet the day-to-day demands of deposit customers balanced by its investments of these deposits. The Company must also be prepared to fulfill the needs of credit customers for loans with various types of maturities and other financing arrangements. The Company monitors its interest rate sensitivity and liquidity through the use of static gap reports which measure the difference between assets and liabilities maturing or repricing within specified time periods as well as financial forecasting/budgeting/reporting software packages.

The following table presents the Company s interest rate sensitivity at various intervals at March 31, 2007:

Rate Sensitivity of Earning Assets and Interest Bearing Liabilities

(dollars in thousands)

	1-30 Days	**31-90 Days**	**91-180 Days**	**181-365 Days**	**Over 1 year**	**Total**
Interest earning assets:						
Federal funds sold and interest bearing deposits	$ 3,066	$	$	$	$	$ 3,066
Debt and equity securities (1)	13,714	45,238	16,277	152,067	169,146	396,442
Loans (2)	307,388	36,738	60,864	91,210	514,574	1,010,774
Total earning assets	$ 324,168	$ 81,976	$ 77,141	$ 243,277	$ 683,720	$ 1,410,282
Interest bearing liabilities:						
Savings and interest bearing demand deposits	$ 15,511	$ 1,916	$ 2,874	$ 5,744	$ 218,321	$ 244,366
Money market savings deposits	283,198					283,198
Time deposits	36,951	54,484	67,519	232,443	108,588	499,985
Federal funds purchased and repurchase agreements	89,902	104	2,323	2,727		95,056
FHLB advances and other borrowings		13,000		5,023		18,023
Total interest bearing liabilities	$ 425,562	$ 69,504	$ 72,716	$ 245,937	$ 326,909	$ 1,140,628
Net asset (liability) funding gap	(101,394)	12,472	4,425	(2,660)	356,811	269,654
Repricing gap	0.76	1.18	1.06	0.99	2.09	1.24
Cumulative repricing gap	0.76	0.82	0.85	0.89	1.24	1.24

(1) Debt and equity securities include securities available-for-sale, securities held-to-maturity and non-marketable equity securities.

(2) Loans are gross and include mortgage loans held-for-sale.

Included in the 1-30 day category of savings and interest-bearing demand deposits are non-core deposits plus a percentage, based upon industry-accepted assumptions and Company analysis, of the core deposits. Core deposits are the lowest average balance of the prior twelve months of each product type included in this category. Non-core deposits are the difference between the current balance and core deposits. The time frames include a percentage, based upon industry-accepted assumptions and Company analysis, of the core deposits, as follows:

	1-30 Days	**31-90 Days**	**91-180 Days**	**181-365 Days**	**Over 1 Year**
Savings and interest-bearing demand deposits	0.45 %	0.85 %	1.25 %	2.45 %	95.00 %

At March 31, 2007, the Company was somewhat liability sensitive due to the levels of savings and interest bearing demand deposits, time deposits and federal funds purchased and repurchase agreements. As such, the effect of an increase in the interest rate for all interest earning assets and interest bearing liabilities of 100 basis points would decrease annualized net interest income by approximately $1.014 million in 30 days and $889,000 in 90 days, assuming no management intervention. A decrease in interest rates would have the opposite effect for the same time periods. The

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Company s Asset and Liability Management Policy states that the cumulative ratio of rate-sensitive assets (RSA) to rate-sensitive liabilities (RSL) for the 12-month period should fall within the range of 0.75-1.25. As of March 31, 2007, the Company s RSA/RSL was 0.89, which was within the established guidelines.

In addition to managing interest rate sensitivity and liquidity through the use of gap reports, the Company has provided for emergency liquidity situations with informal agreements with correspondent banks that permit the Company to borrow federal funds on an unsecured basis. Additionally, at March 31, 2007, the Company had a $15 million unsecured line of credit with a correspondent bank, all of which was available at that date. The Company also has sufficient capacity to permit it to borrow funds from the Federal Home Loan Bank on a secured basis (refer to the Liquidity and Cash Flows section that follows for additional information).

The Company uses financial forecasting/budgeting/reporting software packages to perform interest rate sensitivity analysis for all product categories. The Company s primary focus of its analysis is on the effect of interest rate increases and decreases on net interest income. Management believes that this analysis reflects the potential effects on current earnings of interest rate changes. Call criteria and prepayment assumptions are taken into consideration for investments in debt and equity securities. All of the Company s financial instruments are analyzed by a software database which includes each of the different product categories which are tied to key rates such as prime, Treasury Bills, or the federal funds rate. The relationships of each of the different products to the key rate that the product is tied to is proportional. The software reprices the products based on current offering rates. The software performs interest rate sensitivity analysis by performing rate shocks of plus or minus 200 basis points in 100 basis point increments.

The following table shows projected results at March 31, 2007 and December 31, 2006 of the impact on net interest income from an immediate change in interest rates. The results are shown as a percentage change in net interest income over the next twelve months.

	Basis Point Change			
	+200	**+100**	**-100**	**-200**
March 31, 2007	5.4 %	2.7 %	(2.8)%	(5.7)%
December 31, 2006	4.7 %	2.4 %	(2.5)%	(5.2)%

The foregoing computations are based on numerous assumptions, including relative levels of market interest rates, prepayments and deposit mix. The computed estimates should not be relied upon as a projection of actual results. Despite the limitations on preciseness inherent in these computations, management believes that the information provided is reasonably indicative of the effect of changes in interest rate levels on the net earning capacity of the Company s current mix of interest earning assets and interest bearing liabilities. Management continues to use the results of these computations, along with the results of its computer model projections, in order to enhance earnings potential while positioning the Company to minimize the effect of a prolonged shift in interest rates that would adversely affect future results of operations.

At the present time, the most significant market risk affecting the Company is interest rate risk. Other market risks such as foreign currency exchange risk and commodity price risk do not occur in the normal business of the Company. The Company also is not currently using trading activities or derivative instruments to control interest rate risk.

Liquidity and Cash Flows

The Company requires cash to fund loan growth and deposit withdrawals. Cash flows fluctuate with changes in economic conditions, current interest rate trends and as a result of management strategies and programs. In general, funds provided by customer deposits, federal funds purchased and repurchase agreements, and maturities, calls and paydowns of investment securities are used to fund loans and purchase investment securities. Available funds are used to fund demand for loans that meet the Company s credit quality guidelines, with the remaining funds used to purchase investment securities and/or federal funds sold. The Company monitors the demand for cash and initiates programs and policies as considered necessary to meet funding gaps.

The Company was able to adequately fund loan demand and meet liquidity during the first quarter of 2007. A review of the consolidated statement of cash flows in the accompanying financial statements shows that the Company s cash and cash equivalents decreased $12.555 million from December 31, 2006 to March 31, 2007. The decrease in 2007 resulted from cash used in financing activities and investing activities, offset somewhat by cash provided by operating activities. There were differences in sources and uses of cash during 2007 compared to 2006. Less cash was used in financing activities during the first quarter of 2007 compared to the same period in 2006, primarily due to differences in deposits, federal funds purchased and repurchase agreements and payments on Federal Home Loan Bank and other borrowings. Cash used by financing activities during the first quarter of 2007 was $12.487 million compared to cash used of $48.762 million during the same period in 2006. In 2007, cash provided by deposits of $9.288 million was the result of an increase in interest bearing deposits of $19.387 million, offset somewhat by a $10.099 million decrease in non-interest bearing deposits. During 2006, cash used by deposits of $23.247 million was primarily the result of a decrease in non-interest bearing deposits. In 2007, cash used by federal funds purchased and repurchase agreements of $13.267 million was the result of a $14.242 million decrease in repurchase agreements, offset slightly by a $975,000 increase in federal funds purchased. In 2007, payments on Federal Home Loan Bank advances and other borrowings of $6.454 million was mainly the result of the maturities of $5.431 million of Federal Home Loan Bank advances and the repayment of a $1.000 million borrowing from a bank. During 2006, payments on Federal Home Loan Bank and other borrowings of $19.620 million was mainly the result of the maturities of $18.000 million of Federal Home Loan Bank advances.

Cash was used by investing activities during the first quarter of 2007 compared to cash provided during the same period in 2006, primarily due to differences in activities in the loan portfolio and in investments in debt and equity securities. Cash used by loans during the first quarter of 2007 was $8.468 million as a result of an increase in gross loans, compared to cash provided by loans during the first quarter of 2006 of $40.358 million due to a decrease in gross loans. Cash provided by activities related to investments in debt and equity securities during the first quarter of 2007 was $6.569 million compared to cash used of $34.419 million during the same period in 2006. During the first quarter of 2007, proceeds of $27.863 million from maturities, calls and sales of debt and equity securities, principal paydowns on mortgage-backed securities and return of principal on other equity securities were offset somewhat by cash used to purchase debt and equity securities of $21.294 million. During the same period in 2006, cash used to purchase debt and equity securities of $43.532 million was offset somewhat by proceeds from maturities, calls and sales of debt and equity securities, principal paydowns from mortgage-backed securities and return of principal on other equity securities of $9.113 million. More cash was provided by operating activities in 2007 compared to 2006.

The Company s future short-term cash requirements are expected to be provided by maturities and sales of investments, sales of loans and deposits. Cash required to meet longer-term liquidity requirements will mostly depend on future goals and strategies of management, the competitive environment, economic factors and changes in the needs of customers. If current sources of liquidity cannot provide needed cash in the future, the Company can obtain long-term funds from several sources, including, but not limited to, utilizing the Company s $15 million line of credit from a correspondent bank, FHLB advances and brokered CDs. To meet short-term liquidity needs, the Company is able to borrow funds on a temporary basis from the Federal Reserve Bank, the FHLB and correspondent banks. With sound capital levels, the Company continues to have several options for longer-term cash needs, such as for future expansion and acquisitions.

Management is not aware of any current recommendations by the Company s primary regulators which if implemented would have a material effect on the Company s liquidity, capital resources or operations.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting standards generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures of contingent assets and liabilities. Actual results could differ from those estimates under different assumptions and conditions. The Company believes that it has one critical accounting policy, allowance for loan losses, that is subject to estimates and judgements used in the preparation of its consolidated financial statements, and is described in more detail below.

Provision and Allowance for Loan Losses

The provision for loan losses is based on management s evaluation of the loan portfolio in light of national and local economic conditions, changes in the composition and volume of the loan portfolio, changes in the volume of past due and nonaccrual loans, and other relevant factors. The allowance for loan losses, which is reported as a deduction from loans, is available for loan charge-offs. The allowance is increased by the provision charged to expense and is reduced by loan charge-offs net of loan recoveries. The allowance is allocated between the commercial, financial and agricultural; commercial real estate; residential real estate; and installment and consumer loan portfolios according to the historical losses experienced in each of these portfolios as well as the current level of watch list loans and nonperforming loans for each portfolio. Loans for which borrower cash flow and the estimated liquidation value of collateral are inadequate to repay the total outstanding balance are evaluated separately and assigned a specific allocation. The unallocated portion of the allowance is determined by economic conditions and other factors mentioned above. The balance of the allowance for loan losses was $13.731 million at March 31, 2007 compared to $14.437 million at December 31, 2006, a decrease of $706,000. Net charge-offs were $1.306 million and the provision totaled $600,000 during the first three months of 2007 compared to net charge-offs of $323,000 and provision of $450,000 for the first three months of 2006. The increase in charge-offs during the first quarter of 2007 was primarily due to a $1.000 million charge-off of a commercial real estate credit totaling $4.130 million. A specific allocation of $1.000 million was also maintained on the credit and the remaining amount appears to be adequately secured by the subject real estate. The allowance for loan losses as a percentage of gross loans, including loans held-for-sale, was 1.36% at March 31, 2007, compared to 1.44% at December 31, 2006. Gross loans, including loans held-for-sale, increased 0.8% to $1.011 billion at March 31, 2007 from $1.003 billion at December 31, 2006.

One measure of the adequacy of the allowance for loan losses is the ratio of the allowance to nonperforming loans. The allowance for loan losses as a percentage of nonperforming loans was 161.4% at March 31, 2007 compared to 175.8% at December 31, 2006. Nonperforming loans increased from $8.213 million at December 31, 2006 to $8.509 million at March 31, 2007. The $296,000 increase in nonperforming loans during the first three months of 2007 resulted from a $46,000 increase in nonaccrual loans and an increase of $250,000 in loans past due 90 days or more. The increase in nonaccrual loans was due to an increase in commercial, financial and agricultural loans, offset somewhat by decreases in commercial real estate, residential real estate and consumer loans. The increase in loans past due 90 days or more was due to increases in commercial, financial and agricultural, commercial real estate and consumer loans, offset somewhat by a decrease in residential real estate loans. Management believes that nonperforming and potential problem loans are appropriately identified and monitored based on the extensive loan analysis performed by the credit administration department, the internal loan committees and the board of directors. Historically, there have not been a significant amount of loans charged off which had not been previously identified as problem loans by the credit administration department or the loan committees.

The following table summarizes changes in the allowance for loan losses by loan categories for each period and additions to the allowance for loan losses, which have been charged to operations.

Allowance for Loan Losses

(dollars in thousands)

	March 31, 2007	March 31, 2006
Allowance for loan losses at beginning of year	$ 14,437	$ 13,472
Charge-offs during period:		
Commercial, financial and agricultural	$	$ (165)
Commercial real estate	(1,000)	(67)
Residential real estate	(30)	(71)
Installment and consumer	(357)	(105)
Total	$ (1,387)	$ (408)
Recoveries of loans previously charged off:		
Commercial, financial and agricultural	$ 10	$ 1
Commercial real estate		
Residential real estate		
Installment and consumer	71	84
Total	$ 81	$ 85
Net (charge-offs) recoveries	$ (1,306)	$ (323)
Provision for loan losses	600	450
Allowance for loan losses at end of quarter	$ 13,731	$ 13,599
Ratio of net charge-offs to average net loans	(0.13)%	(0.03)%

The following table shows the allocation of the allowance for loan losses allocated to each category.

Allocation of the Allowance for Loan Losses

(in thousands)

	March 31, 2007	December 31, 2006
Allocated:		
Commercial, financial and agricultural	$ 5,311	$ 5,245
Commercial real estate	6,368	6,772
Residential real estate	420	424
Installment and consumer	1,130	1,218
Total allocated allowance	$ 13,229	$ 13,659
Unallocated allowances	502	778
Total	13,731	14,437

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The following table presents the aggregate amount of loans considered to be nonperforming for the periods indicated. Nonperforming loans include loans accounted for on a nonaccrual basis, accruing loans contractually past due 90 days or more as to interest or principal payments and loans which are troubled debt restructurings as defined in Statement of Financial Accounting Standards No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings.

Nonperforming Loans (dollars in thousands)

	March 31, 2007	December 31, 2006
Nonaccrual loans(1)	$ 7,515	$ 7,469
Loans past due 90 days or more	$ 994	$ 744
Restructured loans(2)	$ 14	$ 231

(1) Includes $2.396 million at March 31, 2007 and $2.471 million at December 31, 2006 of loans which management does not consider impaired as defined by the Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan (SFAS 114).

(2) Loans reported as restructured are performing in accordance with their new terms, are not 90 days past due or more, and are not on nonaccrual status. Therefore, the Company excludes these loan balances in the calculations of its nonperforming loan ratios and percentages.

Other Nonperforming Assets (dollars in thousands)

	March 31, 2007	December 31, 2006
Other real estate owned	$ 75	$ 171
Nonperforming other assets	$ 24	$ 6

Results of Operations

Results of Operations for the Three Months Ended March 31, 2007

Net income for the first three months of 2007 was $4.774 million, an $84,000, or 1.8%, increase from $4.690 million for the same period in 2006. Basic earnings per share increased $0.02, or 4.3%, to $0.48 per share in the first three months of 2007 from $0.46 per share in the first three months of 2006. Diluted earnings per share increased $0.01, or 2.2%, to $0.47 per share in the first three months of 2007 from $0.46 per share in the first three months of 2006.

The following schedule Consolidated Average Balance Sheet and Interest Rates provides details of average balances, interest income or interest expense, and the average rates for the Company s major asset and liability categories.

Consolidated Average Balance Sheet and Interest Rates

(dollars in thousands)

	Three Months Ended March 31, 2007 Average Balance	**Interest**	**Rate**		**2006 Average Balance**	**Interest**	**Rate**	
Assets								
Taxable investment securities(1)	$ 384,145	$ 4,362	4.61	%	$ 436,872	$ 4,106	3.81	%
Tax-exempt investment securities(1) (TE)	22,250	371	6.76	%	32,820	508	6.28	%
Federal funds sold and interest bearing deposits(2)	12,028	248	8.36	%	20,024	297	6.02	%
Loans(3),(4) (TE)	990,094	18,005	7.38	%	977,086	16,800	6.97	%
Total interest earning assets and interest income (TE)	$ 1,408,517	$ 22,986	6.62	%	$ 1,466,802	$ 21,711	6.00	%
Cash and due from banks	$ 46,091				$ 46,121			
Premises and equipment	23,369				23,040			
Other assets	61,157				59,149			
Total assets	$ 1,539,134				$ 1,595,112			
Liabilities and Shareholders Equity								
Interest bearing demand deposits	$ 69,564	$ 116	0.68	%	$ 72,027	$ 110	0.62	%
Savings	447,865	3,511	3.18	%	488,648	3,216	2.67	%
Time deposits	502,297	5,635	4.55	%	466,913	4,092	3.55	%
Federal funds purchased and repurchase agreements	107,201	1,293	4.89	%	122,966	1,151	3.80	%
FHLB advances and other borrowings	20,438	287	5.70	%	58,245	681	4.74	%
Total interest bearing liabilities and interest expense	$ 1,147,365	$ 10,842	3.83	%	$ 1,208,799	$ 9,250	3.10	%
Non-interest bearing demand deposits	$ 147,323				$ 149,487			
Non-interest bearing savings deposits	74,266				72,878			
Other liabilities	18,216				19,071			
Total liabilities	$ 1,387,170				$ 1,450,235			
Shareholders equity	151,964				144,877			
Total liabilities and shareholders equity	$ 1,539,134				$ 1,595,112			
Interest spread (average rate earned minus average rate paid) (TE)			2.79	%			2.90	%

Net interest income (TE)	$	12,144			$	12,461		
Net yield on interest earnings assets (TE)			3.50	%			3.45	%

See next page for Notes 1-4.

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Notes to Consolidated Average Balance Sheet and Interest Rates Tables:

(1) Investments in debt securities are included at carrying value. Income from taxable investment securities included net losses on venture capital funds of approximately $81,000 and $226,000 in 2007 and 2006, respectively. Due to the nature of venture capital investments, future results cannot be predicted based on past performance.

(2) Federal funds sold and interest bearing deposits included approximately $67,000 in 2007 and $65,000 in 2006 of interest income from third party processing of cashier checks.

(3) Loans are net of allowance for loan losses and include mortgage loans held-for-sale. Nonaccrual loans are included in the total.

(4) Loan fees of approximately $240,000 and $383,000 in 2007 and 2006, respectively, were included in total loan income.

Net interest income, the most significant component of the Company s earnings, is the difference between interest received or accrued on the Company s earning assets primarily loans and investments and interest paid or accrued on deposits and borrowings. In order to compare the interest generated from different types of earning assets, the interest income on certain tax-exempt investment securities and loans is increased for analysis purposes to reflect the income tax savings provided by the tax-exempt assets. The adjustment to interest income for tax-exempt investment securities and loans was calculated based on the federal income tax statutory rate of 35%. The following table presents, on a tax equivalent (TE) basis, an analysis of changes in net interest income resulting from changes in average volumes of earning assets and interest bearing liabilities and average rates earned and paid. The change in interest due to the combined rate/volume variance has been allocated to rate and volume changes in proportion to the absolute dollar amounts of change in each.

Analysis of Volume and Rate Changes

(in thousands)

Three Months Ended March 31, 2007

	Increase (Decrease) from Previous Year	**Due to Volume**	**Due to Rate**
Interest Income			
Taxable investment securities	$ 256	$ (533)	$ 789
Tax-exempt investment securities (TE)	(137)	(174)	37
Federal funds sold and interest bearing deposits	(49)	(142)	93
Loans (TE)	1,205	226	979
Total interest income (TE)	$ 1,275	$ (623)	$ 1,898
Interest Expense			
Interest bearing demand and savings deposits	$ 301	$ (270)	$ 571
Time deposits	1,543	328	1,215
Federal funds purchased and repurchase agreements	142	(161)	303
FHLB advances and other borrowings	(394)	(510)	116
Total interest expense	$ 1,592	$ (613)	$ 2,205
Net Interest Income (TE)	$ (317)	$ (10)	$ (307)

Net interest income on a tax equivalent basis was $317,000, or 2.5%, lower for the first three months of 2007 compared to the same period of 2006. Total tax-equivalent interest income was $1.275 million, or 5.9%, higher in 2007 compared to 2006, while interest expense increased $1.592 million, or 17.2%. The increase in tax-equivalent interest income and interest expense was due to higher rates offset somewhat by lower volume.

The increase in total tax-equivalent interest income was due to an increase in interest income from loans and taxable investment securities, offset somewhat by a decrease in interest income from tax-exempt investment securities

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and federal funds sold and interest bearing deposits. The increase in interest income from loans was due to both higher rates and an increase in volume. The increase in interest income from taxable investment securities was due to higher rates offset somewhat by lower volume. The decrease in interest income from tax-exempt investment securities was primarily due to lower volume. The decrease in federal funds sold and interest bearing deposits was due to lower volume offset somewhat by an increase in rates.

The increase in total interest expense was due to an increase in interest expense from time deposits, interest bearing demand and savings deposits and federal funds purchased and repurchase agreements, offset somewhat by a decrease in interest expense from FHLB advances and other borrowings. The increase in interest expense on time deposits was due to an increase in both rates and volume. The increases in interest expense from interest bearing demand and savings deposits and federal funds purchased and repurchase agreements were both due to higher rates offset somewhat by lower volume. The decrease in interest expense from FHLB advances and other borrowings was due to lower volume, offset somewhat by higher rates.

The provision for loan losses recorded was $600,000 during the first three months of 2007 compared to $450,000 during the same period in 2006. The provision was increased in the first quarter of 2007 mainly due to a reduction in the allowance for loan losses as a result of the level of net charge-offs during the period. The provision during both periods was based on management s analysis of the loan portfolio, as discussed in the provision for loan losses section above.

The following table summarizes selected categories of non-interest income and non-interest expense for the three months ended March 31, 2007 and 2006.

Non-interest Income and Expense for the

Three Months Ended March 31,

Non-interest Income (in thousands)	2007	2006	$ change	% change
Trust and brokerage fees (1)	$ 2,158	$ 1,915	$ 243	12.7 %
Remittance processing income (2)	2,279	1,765	514	29.1 %
Service charges on deposit accounts	564	685	(121)	(17.7 %)
Securities transactions, net (3)	(231)	267	(498)	(186.5 %)
Gain on sales of mortgage loans, net (4)	102	126	(24)	(19.0 %)
Other	771	761	10	1.3 %
Total non-interest income	$ 5,643	$ 5,519	$ 124	2.2 %

Non-interest Expense (in thousands)	2007	2006	$ change	% change
Salaries and employee benefits	$ 5,995	$ 5,921	$ 74	1.2 %
Occupancy	794	792	2	0.3 %
Equipment (5)	681	615	66	10.7 %
Data processing (6)	909	738	171	23.2 %
Office supplies	301	296	5	1.7 %
Service charges from correspondent banks	78	64	14	21.9 %
Amortization of core deposit intangibles	217	218	(1)	(0.5 %)
Other	1,367	1,401	(34)	(2.4 %)
Total non-interest expense	$ 10,342	$ 10,045	$ 297	3.0 %

(1) Contributing to the increase in trust and brokerage fees was a $136,000, or 437.2%, increase in income attributable to commissions from the sales of farm real estate due to an increase in closings during the first quarter of 2007 compared to the same period in 2006, and a $167,000, or 12.4%, increase in income from trust fees and employee benefit plan fees as a result of continuing efforts to grow new business and provide excellent service to existing customers.

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(2) The increase in remittance processing income was primarily due to a $239,000, or 25.0%, increase in Internet Agent income as a result of expansion of the agent base by approximately 800 agents at FirsTech, and the subsequent expansion of new and existing customer relationships, $148,000 in income attributable to its new online bill payment product which was introduced in the third quarter of 2006 and an $81,000, or 36.4% increase in currency exchange income as a result of a new product called Expedited Payments that generates higher fees to ensure that payments post quicker.

(3) The loss on securities transactions, net, in 2007 included a $455,000 loss on venture capital funds offset, somewhat, by a $223,000 gain on the sale of the Bank s holdings in other equity investments.

(4) The decrease in gains on sales of mortgage loans, net, in 2007 was due to a $2.328 million, or 20.1%, decrease in mortgage loans funded in the first quarter of 2007 compared to the same period in 2006, primarily as a result of the slowdown in refinancings.

(5) The increase in equipment expense in 2007 included a $64,000, or 18.7%, increase in depreciation expense primarily due to a $72,000 increase attributable to FirsTech due, in part, to the expansion of its Internet Agent base.

(6) The increase in data processing expense in 2007 was primarily due to FirsTech, which had a $79,000, or 2014.7%, increase in programming fees and a $17,000, or 73.8%, increase in software expense due to preparations to open its new office in Clayton, Missouri and $68,000 in expense related to its new online bill payment product.

Income tax expense decreased $672,000, or 25.7%, during the first three months of 2007 compared to the same period in 2006. The effective tax rate decreased to 28.9% during the first three months of 2007 from 35.8% during the same period in 2006. The change in the effective tax rate was primarily due to a $305,000 tax credit in the first quarter of 2007 from a loss on an investment in a low-income housing project.

Business Segment Information

The Company currently operates in two industry segments. The primary business involves providing banking services to central Illinois. The Bank offers a full range of financial services to business and individual customers. These services include demand, savings, time and individual retirement accounts; commercial, consumer (including automobile loans and personal lines of credit), agricultural and real estate lending; safe deposit and night depository services; farm management; farm realty service; full service trust department that offers a wide range of services such as investment management, acting as trustee, serving as guardian, executor or agent, comprehensive financial planning, miscellaneous consulting, and brokerage services offered through a third-party arrangement with Raymond James Financial Services. The other industry segment involves remittance processing. FirsTech provides the following services to electric, water and gas utilities, telecommunication companies, insurance companies, and charitable organizations: retail lockbox processing of payments delivered by mail on behalf of the biller; processing of payments delivered by customers to pay agents such as grocery stores, convenience stores and currency exchanges; concentration of payments delivered by the Automated Clearing House network and other payment processors such as MasterCard RPS, and online bill payment transactions processed on behalf of billers via the Internet.

Company information is provided for informational purposes only, since it is not considered a separate segment for reporting purposes.

The following table quantifies the Company s business segment information for the three-months ended March 31, 2007 and 2006:

As of and for the Three Months Ended:	Banking Services	Remittance Services	Company	Eliminations	Total
March 31, 2007					
Total interest income	$ 22,738	$ 7	$ 127	$ (17)	$ 22,855
Total interest expense	10,854		5	(17)	10,842
Provision for loan losses	600				600
Total non-interest income	4,063	2,355	(453)	(322)	5,643
Total non-interest expense	8,719	1,369	576	(322)	10,342
Income before income tax	6,628	993	(907)		6,714
Income tax expense	2,360	397	(817)		1,940
Net income	4,268	596	(90)		4,774
Goodwill	20,736				20,736
Total assets	1,516,882	5,113	155,847	(148,803)	1,529,039
Depreciation and amortization	535	138	14		687
March 31, 2006					
Total interest income	$ 21,693	$ 6	$ (160)	$ (11)	$ 21,528
Total interest expense	9,173		88	(11)	9,250
Provision for loan losses	450				450
Total non-interest income	3,775	1,824	238	(318)	5,519
Total non-interest expense	8,805	1,156	402	(318)	10,045
Income before income tax	7,040	674	(412)		7,302
Income tax expense	2,498	283	(169)		2,612
Net income	4,542	391	(243)		4,690
Goodwill	20,736				20,736
Total assets	1,567,533	4,043	155,015	(145,222)	1,581,369
Depreciation and amortization	560	66	13		639

Emerging Accounting Standards

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. The Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations and cash flows.

In February 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, which provides all entities, including not-for-profit organizations, with an option to report selected financial assets and liabilities at fair value. The objective of the Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in earnings caused by measuring related assets and liabilities differently without having to apply the complex provisions of hedge accounting. Certain specified items are eligible for the irrevocable fair value measurement option as established by Statement No. 159. Statement No. 159 is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007 provided the entity also elects to apply the provisions of Statement No. 157, Fair Value Measurements. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows.

Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company s management and on information currently available to management, are generally identifiable by the use of words such as believe, expect, anticipate, plan, intend, estimate, will, would, could, should or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries include, and are not limited to, the following:

- Unexpected results of, or the inability to complete, the proposed merger with First Busey Corporation.

- The economic impact of past and any future terrorist attacks, acts of war or threats thereof and the response of the United States to any such threats and attacks.

- The costs, effects and outcomes of existing or future litigation.

- Changes in accounting policies and practices, as may be adopted by state and federal regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public company Accounting Oversight Board.

- The ability of the Company to manage the risks associated with the foregoing as well as anticipated.

In addition to the risk factors described above, there are other factors that may impact any public company, including ours, which could have a material adverse affect on the operations and future prospects of the company and its subsidiaries. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

See the Interest Rate Sensitivity section above.

Item 4. Controls and Procedures

An evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of March 31, 2007. Based on that evaluation, the Company s management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company s disclosure controls and procedures were effective as of March 31, 2007.

There have been no changes in the Company s internal control over financial reporting that occurred during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect the disclosure controls or the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routine litigation incidental to their respective businesses.

Item 1.A. Risk Factors

There have been no material changes in the risk factors applicable to the Company from those disclosed in Part I, Item 1.A. Risk Factors, in the Company s 2006 Annual Report on Form 10-K. Please refer to that section of the Company s 10-K for disclosures regarding the risks and uncertainties related to the Company s business.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

At a special meeting of its shareholders on February 28, 2007, a majority of the shareholders of the Company voted in favor of the proposed merger of Main Street Trust, Inc. and First Busey Corporation. The voting at the special meeting was as follows:

Votes For	Votes Against	Abstentions	Broker Non-Votes
7,637,320	22,565	20,565	0

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13-a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13-a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duty authorized.

MAIN STREET TRUST, INC.

Date: May 9, 2007

By: /s/ David B. White
David B. White, Executive Vice President
And Chief Financial Officer

By: /s/ Van A. Dukeman
Van A. Dukeman, President
And Chief Executive Officer

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