

HOMESTORE INC  
Form 10-Q  
November 05, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

---

Form 10-Q

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

**For the quarterly period ended September 30, 2004**

or

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

**Commission File Number 000-26659**

---

**Homestore, Inc.**

*(Exact Name of Registrant as Specified in its Charter)*

**Delaware**

*(State or Other Jurisdiction of  
Incorporation or Organization)*

**95-4438337**

*(I.R.S. Employer  
Identification No.)*

**30700 Russell Ranch Road  
Westlake Village, California**

*(Address of Principal Executive Offices)*

**91362**

*(Zip Code)*

**(805) 557-2300**

*(Registrant's Telephone Number, including Area Code:)*

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

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

At October 31, 2004, the registrant had 146,721,187 shares of its common stock outstanding.

---

---

**INDEX**

**Page**

**PART I FINANCIAL INFORMATION**

Item 1. Condensed Consolidated Financial Statements

Consolidated Balance Sheets

Unaudited Consolidated Statements of Operations

Unaudited Consolidated Statements of Cash Flows

Notes to Unaudited Condensed Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

**PART II OTHER INFORMATION**

Item 1. Legal Proceedings

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

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits

**SIGNATURES**

EX-10.1

EX-31.1

EX-31.2

EX-32.1

EX-32.2

Homestore.com®, REALTOR.com®, HomeBuilder.com , RENTNET.com®, Top Producer® and Welcome Wagon® are our trademarks or are exclusively licensed to us. This quarterly report on Form 10-Q contains trademarks of other companies and organizations. REALTOR® is a registered collective membership mark that may be used only by real estate professionals who are members of the National Association of REALTORS® and subscribe to its code of ethics.

---

**PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****HOMESTORE, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2004</b>	<b>December 31, 2003</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,830	\$ 13,942
Short-term investments	34,150	21,575
Accounts receivable, net	14,255	14,576
Current portion of prepaid distribution expense		10,509
Assets of discontinued operations	1,180	
Other current assets	13,516	10,585
	<hr/>	<hr/>
Total current assets	76,931	71,187
Property and equipment, net	13,652	21,454
Goodwill, net	19,502	20,477
Intangible assets, net	19,325	25,758
Restricted cash	5,105	
Other assets	6,917	14,672
	<hr/>	<hr/>
Total assets	<b>\$ 141,432</b>	<b>\$ 153,548</b>
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,050	\$ 1,409
Accrued expenses	38,317	42,576
Accrued litigation settlement (see note 12)		53,600
Accrued distribution obligation		7,406
Obligation under capital leases	799	1,535
Deferred revenue	41,032	31,348
Deferred revenue from related parties		4,042
	<hr/>	<hr/>
Total current liabilities	82,198	141,916
Obligation under capital leases	79	369
Deferred revenue	4,330	

Edgar Filing: HOMESTORE INC - Form 10-Q

Deferred revenue from related parties		2,869
Other non-current liabilities	4,208	8,066
	<u>          </u>	<u>          </u>
Total liabilities	90,815	153,220
Commitments and contingencies (see note 13)		
Stockholders' equity:		
Convertible preferred stock		
Common stock	147	122
Additional paid-in capital	2,056,924	1,992,591
Treasury stock, at cost	(14,470)	(14,470)
Deferred stock-based charges	(465)	(258)
Accumulated other comprehensive income	323	267
Accumulated deficit	(1,991,842)	(1,977,924)
	<u>          </u>	<u>          </u>
Total stockholders' equity	50,617	328
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 141,432	\$ 153,548
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

**HOMESTORE, INC.****UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	(In thousands, except per share amounts)			
Revenue	\$ 56,081	\$ 51,588	\$ 166,411	\$ 153,173
Related party revenue		1,336		4,974
Total revenue	56,081	52,924	166,411	158,147
Cost of revenue	13,117	15,006	39,765	44,687
Gross profit	42,964	37,918	126,646	113,460
Operating expenses:				
Sales and marketing	21,573	25,622	68,998	77,827
Product and website development	4,229	4,473	12,636	14,320
General and administrative	22,495	16,687	51,833	51,979
Amortization of intangible assets	1,990	5,935	6,432	19,874
Litigation settlement (see note 12)			2,168	63,600
Impairment of long-lived assets (see note 7)		15,664		27,822
Restructuring charges (see note 6)			345	
Total operating expenses	50,287	68,381	142,412	255,422
Loss from operations	(7,323)	(30,463)	(15,766)	(141,962)
Interest income (expense), net	474	(234)	414	(288)
Gain on settlement of distribution agreement (see note 12)				104,071
Other income, net	2,234	(195)	2,241	749
Loss from continuing operations	(4,615)	(30,892)	(13,111)	(37,430)
Gain on disposition of discontinued operations (see note 5)				2,530
Income (loss) from discontinued operations	42	310	(807)	(167)
Net loss	\$ (4,573)	\$ (30,582)	\$ (13,918)	\$ (35,067)

Edgar Filing: HOMESTORE INC - Form 10-Q

	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Unrealized gain (loss) on marketable securities	(21)	42	9	38
Foreign currency translation	88	(20)	47	419
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Comprehensive loss	\$ (4,506)	\$ (30,560)	\$ (13,862)	\$ (34,610)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Basic and diluted net income (loss) per share applicable to common stockholders (see note 10):				
Continuing operations	\$ (0.03)	\$ (0.26)	\$ (0.10)	\$ (0.32)
Discontinued operations	0.00	0.00	(0.01)	0.02
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	(0.03)	(0.26)	(0.10)	(0.30)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Shares used to calculate basic and diluted net income (loss) per share applicable to common stockholders:				
Basic and diluted	145,823	119,418	133,226	118,566
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

**HOMESTORE, INC.****UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(In thousands)</b>	
<b>Cash flows from continuing operating activities:</b>		
Loss from continuing operations	\$(13,111)	\$ (37,430)
Adjustments to reconcile net loss to net cash provided by (used in) continuing operating activities:		
Depreciation	6,280	8,958
Amortization of intangible assets	6,432	19,874
Gain on sale of property and equipment	(1,354)	
Impairment of long-lived assets		27,822
Provision for doubtful accounts	64	2,152
Stock-based charges	685	5,004
Gain on settlement of distribution agreement		(104,071)
Other non-cash items	414	601
Changes in operating assets and liabilities, net of discontinued operations:		
Accounts receivable	(253)	5,196
Prepaid distribution expense	10,509	17,722
Restricted cash	(5,105)	90,000
Other assets	4,974	(758)
Accounts payable and accrued expenses	(1,570)	48,570
Accrued distribution agreement	(7,406)	(108,496)
Deferred revenue	7,248	4,121
Deferred revenue from related parties		(5,690)
Net cash provided by (used in) continuing operating activities	7,807	(26,425)
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(3,953)	(6,602)
Maturities of short term investments	1,000	
Purchases of short term investments	(13,575)	(20,975)
Proceeds from sale of assets	6,013	1,320
Net cash used in investing activities	(10,515)	(26,257)
<b>Cash flows from financing activities:</b>		
Proceeds from payment of stockholders' notes		61
Proceeds from exercise of stock options, warrants and share issuances under employee stock purchase plan	3,266	2,242



Edgar Filing: HOMESTORE INC - Form 10-Q

Net cash provided by financing activities	<u>3,266</u>	<u>2,303</u>
Net cash provided by (used in) continuing activities	558	(50,379)
Net cash provided by (used in) discontinued operations	<u>(670)</u>	<u>1,627</u>
Change in cash and cash equivalents	(112)	(48,752)
Cash and cash equivalents, beginning of period	<u>13,942</u>	<u>80,463</u>
Cash and cash equivalents, end of period	<u>\$ 13,830</u>	<u>\$ 31,711</u>

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

---

## HOMESTORE, INC.

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Business

Homestore, Inc. ( Homestore or the Company ) has created an online service that is the leading consumer destination on the Internet for home and real estate-related information, products and media services, based on the number of visitors, time spent on the websites and number of property listings. The Company provides a wide variety of information and tools for consumers and is a leading supplier of online media and technology solutions for real estate industry professionals, advertisers and providers of home and real estate-related products and services. The Company derives all of its revenue from its North American operations.

To provide consumers with timely and comprehensive real estate listings, access to real estate professionals and other home and real estate-related information and resources, the Company has established relationships with key industry participants. These participants include real estate market leaders such as the National Association of REALTORS® ( NAR ), the National Association of Home Builders ( NAHB ), hundreds of Multiple Listing Services ( MLSs ), the Manufactured Housing Institute ( MHI ), and leading real estate franchisors, including the six largest franchises, brokers, builders, and apartment owners. Under an agreement with NAR, the Company operates NAR's official website, REALTOR.com®. Under an agreement with NAHB, the Company operates its new home listing website, HomeBuilder.com. Under agreements with NAR, NAHB, and MHI, the Company receives preferential promotion in their marketing activities.

Since inception, the Company has incurred losses from operations and has reported negative operating cash flows. As of September 30, 2004, the Company had an accumulated deficit of \$2.0 billion and cash and short-term investments of \$48.0 million. The Company has no material financial commitments other than those under capital and operating lease agreements and distribution and marketing agreements. The Company believes that its existing cash and short-term investments, and any cash generated from operations, will be sufficient to fund its working capital requirements, capital expenditures and other obligations through the next 12 months. Long term, the Company may face significant risks associated with the successful execution of its business strategy and may need to raise additional capital in order to fund more rapid expansion, to expand its marketing activities, to develop new or enhance existing services or products and to respond to competitive pressures or to acquire complementary services, businesses or technologies. If the Company is not successful in continuing to generate sufficient cash flow from operations, it may need to raise additional capital through public or private financing, strategic relationships or other arrangements. The Company's settlement of the Securities Class Action Lawsuit (see Note 12) has reduced its cash balance by \$13.0 million, and has increased the number of outstanding shares of the Company's common stock by 20.0 million, which may make it more difficult to raise additional capital. This additional capital, if needed, might not be available on terms acceptable to the Company, or at all. If additional capital were raised through the issuance of equity securities, the percentage of the Company's stock owned by its then-current stockholders would be further reduced. Furthermore, these equity securities might have rights, preferences or privileges senior to those of the Company's common and preferred stock. In addition, the Company's liquidity could be adversely impacted by other litigation (see Note 13).

#### 2. Basis of Presentation

The Company's unaudited Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) including those for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X issued by the Securities and

Exchange Commission ( SEC ). Accordingly, they do not include all of the information and note disclosures required by GAAP for complete financial statements. These statements are unaudited and, in the opinion of management, all adjustments (which include only normal recurring adjustments) considered necessary for a fair presentation have been included. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2003 included in the Company's Form 10-K filed with the SEC on March 15, 2004. The results of operations for these interim periods are not necessarily indicative of the operating results for a full year. As a result of the Company's sale of its Wyldfyre business, Wyldfyre's results have been reclassified as discontinued operations for all periods presented (See Note 5).

---

### 3. Significant Accounting Policy

The Company follows the intrinsic value method in accounting for its stock options. Had compensation cost been recognized based on the fair value at the date of grant for options granted during the three and nine months ended September 30, 2004 and September 30, 2003, the pro forma amounts of the Company's net loss per share would have been as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss applicable to common stockholders:				
As reported	\$ (4,573)	\$ (30,582)	\$ (13,918)	\$ (35,067)
Add: Stock-based employee compensation charges included in reported net loss		370	300	929
Deduct: Total stock-based compensation determined under fair value-based method for all awards	(4,139)	(4,482)	(11,752)	(11,988)
Pro forma net loss	<u>\$ (8,712)</u>	<u>\$ (34,694)</u>	<u>\$ (25,370)</u>	<u>\$ (46,126)</u>
Net income (loss) per share:				
Basic and diluted as reported	\$ (0.03)	\$ (0.26)	\$ (0.10)	\$ (0.30)
Basic and diluted pro forma	\$ (0.06)	\$ (0.29)	\$ (0.19)	\$ (0.39)

The fair value for each option granted was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

	Three months Ended September 30,		Nine months Ended September 30,	
	2004	2003	2004	2003
Risk-free interest rates	4.0%	3.0%	3.4%	3.0%
Expected lives (in years)	4	4	4	4
Dividend yield	0%	0%	0%	0%
Expected volatility	134%	142%	139%	142%

### 4. Recent Accounting Developments

In January 2003, the Financial Accounting Standards Board ( FASB ) issued interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin ( ARB ) No. 51 ( FIN 46 ). FIN 46 provides

guidance for determining whether and how to consolidate variable interest entities ( VIEs ). Variable interests are contractual, ownership or other interests in an entity that expose their holders to the risks and rewards of the VIEs. Variable interests include equity investments, loans, leases, derivatives, guarantees and other instruments whose values change with changes in the VIE s assets. Any of these instruments may require its holder to consolidate the VIEs. FIN 46 requires certain VIEs to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. For entities created before January 31, 2003, the provisions of FIN 46 were delayed until March 31, 2004. The adoption of FIN 46 in the first quarter of 2004 did not have a material impact on the Company s financial position, results of operations, or financial statement disclosures.

## 5. Discontinued Operations

On October 6, 2004, the Company entered into an Asset Purchase Agreement with Wyld Acquisition Corp. ( Wyld ), a wholly owned subsidiary of Siegel Enterprises, Inc., pursuant to which the Company agreed to sell its WyldFyre software business, which had been reported as part of the Company s software segment, to Wyld for a purchase price of \$8.5 million in cash. The transaction closed on October 6, 2004. The Company received net cash proceeds of \$7.0 million after transaction fees and monies placed in escrow pursuant to the Asset Purchase Agreement.

Pursuant to Statement of Financial Accounting Standards ( SFAS ) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"( SFAS No. 144 ), the consolidated financial statements of Homestore reflect the disposition of its WyldFyre business as discontinued operations. Accordingly, the revenue, cost and expenses, and cash flows of the WyldFyre business through September 30, 2004, have been excluded from the respective captions in the Consolidated Statements of Operations and Consolidated Statements of Cash Flows and have been reported as

Income (loss) from discontinued operations , net of applicable income taxes of zero; and as Net cash provided by (used in) discontinued operations. Previously reported results have been reclassified to reflect this presentation. The assets of WyldFyre have been excluded from the respective captions in the September 30, 2004 Consolidated

---

Balance Sheet, and are reported as Assets of discontinued operations. The Company retained accounts receivable of approximately \$1.2 million after the sale. The gain associated with the disposition of WyldFyre will be recorded in the fourth quarter of 2004 and is estimated to be approximately \$6.5 million. Total revenue was \$1.5 million and \$4.1 million for the three and nine months ended September 30, 2004, respectively, and income from discontinued operations was approximately \$42,000 for the three months ended September 30, 2004, with a loss from discontinued operations of approximately \$807,000 for the nine months ended September 30, 2004. For the three and nine months ended September 30, 2003, total revenue was \$2.2 million and \$5.7 million, respectively, with income from discontinued operations of approximately \$310,000 for the three months ended September 30, 2003 and a loss from discontinued operations of approximately \$167,000 for the nine months ended September 30, 2003.

The carrying amounts of the major classes of assets of the discontinued operations at September 30, 2004 are as follows (in thousands):

	<b>September 30, 2004</b>
Property and equipment	\$ 205
Goodwill, net	975
	<hr/>
Total assets of discontinued operations	\$ 1,180

On March 19, 2002, the Company entered into an agreement to sell its ConsumerInfo division, which the Company purchased as part of the acquisition of iPlace, Inc. ( iPlace ), for \$130.0 million in cash to Experian Holdings, Inc. ( Experian ). The transaction closed on April 2, 2002, resulting in a gain on disposition of discontinued operations. The sale generated net proceeds of approximately \$94.1 million after transaction fees and monies paid in settlement of litigation. Pursuant to SFAS No. 144, the unaudited Condensed Consolidated Financial Statements of the Company for all periods presented reflect the disposition of its ConsumerInfo division as discontinued operations. To date, \$14.3 million has been recorded as Gain on disposition of discontinued operations.

As part of the sale, \$10.0 million of the purchase price was put in escrow to secure the Company's indemnification obligations. As a result of the Company's initial purchase of iPlace, the Company had a claim against the original escrow established at the time of acquisition. In the fourth quarter of 2002, the Company reached a settlement of that claim with the largest former shareholder and extended that settlement offer to other former shareholders. As a result of the acceptance of that offer by a number of shareholders, the Company received cash and stock valued at \$229,000 for the three months ended March 31, 2003 and recorded a gain on disposition of discontinued operations during that same period. In April 2003, \$2.3 million of escrow proceeds were released to the Company in accordance with the agreement and was recognized as additional Gain on disposition of discontinued operations in the unaudited Consolidated Statement of Operations for the nine months ended September 30, 2003. The escrow was scheduled to terminate in the fourth quarter of 2003, but in the third quarter of 2003, Experian demanded indemnification from the Company for several claims made against Experian or its subsidiaries. The Company is evaluating these indemnity claims and is unable to express an opinion at this time as to their merits, however these potential claims against the escrow could reduce or delay the release.

As of September 30, 2004, cash subject to the escrow was \$7.3 million. To the extent the escrow is released to the Company, the Company will recognize additional gain on disposition of discontinued operations.

## 6. Restructuring Charges

The Company has taken four restructuring charges: in the fourth quarter of 2001, the first quarter of 2002, the third quarter of 2002 and the fourth quarter of 2003. All of these charges were a part of plans approved by the Company's Board of Directors, with the objective of eliminating duplicate resources and redundancies. A summary of each is outlined below.

In the fourth quarter of 2001, the Company recorded a charge of \$35.8 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, the Company undertook a review of its existing locations and elected to close a number of satellite offices and identified and notified approximately 700 employees whose positions with the Company were eliminated. The work force reductions affected approximately 150 members of management, 100 in research and development, 200 in sales and marketing and 250 in administrative functions. This charge consisted of the following: (i) employee termination benefits of \$6.4 million; (ii) facility closure charges of \$20.8 million, comprised of \$12.8 million in future lease obligations, exit costs and cancellation penalties, net of estimated sublease income of \$11.9 million, and \$8.0 million of non-cash fixed asset disposals related to vacating duplicate facilities and decreased equipment requirements due to lower headcount; (iii) non-cash write-offs of \$2.9 million in other assets related to exited activities; and (iv) accrued future payments of \$5.7 million for existing contractual obligations with no future benefits to the Company.

In the first quarter of 2002, the Company revised its estimates related to a lease obligation and reduced the charge by \$488,000. During the second quarter of 2002, the Company revised its estimates related to its contractual obligations and reduced the charge by \$459,000. The Company's original estimate with respect to sublease income related primarily to a lease commitment for office space in San Francisco that expires in November 2006. The Company originally estimated that it would sublease the facility by the second quarter of 2003 at a rate of approximately two-thirds of the existing commitment. However, declines in the demand for office space in the San Francisco market led the Company to revise those estimates. Because the Company believed in 2002 it would take at least one year longer than it originally estimated to sublease the property and the market rates are projected to be as low as 33% of the Company's current rent, the Company took an additional \$6.5 million charge in the third quarter of 2002. The Company also reduced

---

its estimates for employee termination benefits by \$396,000 and its contractual obligations by \$339,000. In the fourth quarter of 2003, the Company took an additional charge of approximately \$1.3 million for lease obligations and related charges because the Company believed it would take at least one year longer than it originally estimated to sublease the last one third of the San Francisco property and decreased its estimate related to its contractual obligations by \$203,000 and employee termination benefits by \$10,000. In the first quarter of 2004, the Company increased its estimate for lease obligations and related charges for its San Francisco property by \$139,000. As of September 30, 2004, one of the planned 700 employees previously notified of termination has not yet been paid severance.

In the first quarter of 2002, the Company recorded a charge of \$2.3 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, the Company undertook a review of its existing locations and elected to close offices and identified and notified approximately 270 employees whose positions with the Company were eliminated. The work force reductions affected approximately 30 members of management, 40 in research and development, 140 in sales and marketing and 60 in administrative functions. This charge consisted of employee termination benefits of \$1.7 million and facility closure charges of approximately \$600,000. In the third quarter of 2002, the Company evaluated its original estimates and concluded it must increase its charge for lease obligations by \$1.6 million because of a decline in market rates and reduce its estimate for employee termination pay by \$242,000. In the fourth quarter of 2003, the Company decreased its estimate for employee termination benefits by \$14,000 and increased its estimate for lease obligations and related charges by \$46,000. In the first quarter of 2004, the Company increased its charge for lease obligations by \$277,000 as a result of changes in exchange rates which increased its Canadian lease obligations. As of September 30, 2004, all of the planned 270 employees have been terminated and paid severance.

In the third quarter of 2002, the Company recorded a charge of \$3.6 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, the Company undertook a review of its existing locations and elected to close an office and identified and notified approximately 190 employees whose positions with the Company were eliminated. The work force reductions affected approximately 30 in research and development, 10 in production, 140 in sales and marketing and 10 in administrative functions. This charge consisted of employee termination benefits of \$1.6 million and facility closure charges of approximately \$2.0 million. In the fourth quarter of 2003, the Company decreased its estimates regarding employee termination benefits by \$133,000 and its lease obligations and related charges by \$417,000. As of September 30, 2004, all of the planned 190 employees have been terminated and paid severance.

In the fourth quarter of 2003, the Company recorded a charge of \$3.5 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, the Company undertook a review of its existing operations and elected to change its management structure and identified and notified approximately 95 employees whose positions with the Company were eliminated. The work force reductions affected approximately seven in research and development, 17 in production, 37 in sales and marketing and 34 in administrative functions. This charge consists of employee termination benefits of \$1.4 million and stock-based charges related to the acceleration of vesting of certain options for terminated management personnel of \$2.1 million. In the first quarter of 2004, the Company reduced its estimate for employee termination benefits by \$71,000. As of September 30, 2004, all of the planned 95 employees previously notified of termination have been paid severance.

A summary of activity related to the four restructuring charges and the changes in the Company's estimates is as follows (in thousands):

**Lease  
Stock-based Obligations**



	<b>Employee Termination Benefits</b>	<b>charges for Accelerated Vesting</b>	<b>and Related Charges</b>	<b>Asset Write-offs</b>	<b>Contractual Obligations</b>	<b>Total</b>
December 2001 restructuring charge	\$ 6,364	\$	\$ 12,782	\$ 10,917	\$ 5,733	\$ 35,796
Cash paid	(3,511)		(137)		(141)	(3,789)
Non-cash charges				(10,917)		(10,917)
Restructuring accrual at December 31, 2001	2,853		12,645		5,592	21,090
March 2002 restructuring charge	1,720		309	260		2,289
Cash paid	(2,844)		(1,222)		(1,155)	(5,221)
Change in estimates			(488)			(488)
Non-cash charges			488	(260)		228
Restructuring accrual at March 31, 2002	1,729		11,732		4,437	17,898
Cash paid	(224)		(1,804)		(1,249)	(3,277)
Change in estimates					(459)	(459)
Sale of a subsidiary	(156)					(156)
Restructuring accrual at June 30, 2002	1,349		9,928		2,729	14,006
September 2002 restructuring charge	1,590		2,033			3,623
Cash paid	(693)		(1,492)		(707)	(2,892)
Change in estimates	(638)		8,099		(339)	7,122
Restructuring accrual at September 30, 2002	1,608		18,568		1,683	21,859

	<b>Employee Termination Benefits</b>	<b>Lease Stock-based charges for Accelerated Vesting</b>	<b>Lease Obligations and Related Charges</b>	<b>Asset Write-offs</b>	<b>Contractual Obligations</b>	<b>Total</b>
Cash paid	(1,155)		(1,402)	-	(520)	(3,077)
Restructuring accrual at December 31, 2002	453		17,166		1,163	18,782
Cash paid	(59)		(2,127)	-	(327)	(2,513)
Restructuring accrual at March 31, 2003	394		15,039		836	16,269
Cash paid	(216)		(1,671)	-	(180)	(2,067)
Restructuring accrual at June 30, 2003	178		13,368		656	14,202
Cash paid	(10)		(1,181)	-	(79)	(1,270)
Restructuring accrual at September 30, 2003	168		12,187		577	12,932
December 2003 restructuring charge	1,401	2,140				3,541
Cash paid	(511)		(1,496)		10	(1,997)
Change in estimates	(157)		919		(203)	559
Non-cash charges		(2,140)		-		(2,140)
Restructuring accrual at December 31, 2003	901		11,610		384	12,895
Cash paid	(737)		(1,425)		(4)	(2,166)
Change in estimates	(71)		416			345
Restructuring accrual at March 31, 2004	93		10,601		380	11,074
Cash paid	(54)		(1,058)	-	(4)	(1,116)
Restructuring accrual at June 30, 2004	39		\$ 9,543		376	9,958
Cash paid	(18)		(1,005)			(1,023)

Restructuring accrual at September 30, 2004	\$ 21	\$	\$ 8,538	\$	\$ 376	\$ 8,935
--	-------	----	----------	----	--------	----------

With the exception of payments associated with the San Francisco and other office lease commitments, substantially all of the remaining restructuring liabilities at September 30, 2004 will be paid during 2004. Any further changes to the accruals based upon current estimates will be reflected through the restructuring charges line in the Consolidated Statement of Operations.

## 7. Goodwill and Other Intangible Assets

Goodwill, net, by segment, as of September 30, 2004 and December 31, 2003 is as follows (in thousands):

	<b>September 30, 2004</b>	<b>December 31, 2003</b>
Media services	\$ 1,307	\$ 1,307
Software	11,681	12,656
Print	6,514	6,514
Total	<u>\$19,502</u>	<u>\$20,477</u>

Definite-lived intangible assets consist of purchased content, porting relationships, purchased technology, and other miscellaneous agreements entered into in connection with business combinations and are amortized over expected periods of benefits. There are no indefinite lived intangibles and no expected residual values related to these intangible assets (in thousands):

	<b>September 30, 2004</b>		<b>December 31, 2003</b>	
	<b>Gross Amount</b>	<b>Accumulated Amortization</b>	<b>Gross Amount</b>	<b>Accumulated Amortization</b>
Trade name, trademarks, websites and brand names	\$19,746	\$ 5,132	\$19,746	\$ 4,032
Customer lists and relationships	18,786	18,325	18,786	18,081
Purchased technology	9,325	8,187	9,325	6,822
Purchased content	7,631	7,418	7,631	5,248
Porting relationships	1,728	1,677	1,728	1,220
NAR operating agreement	1,578	413	1,578	301
Online traffic	533	533	533	320
Other	5,844	4,160	5,844	3,389

Edgar Filing: HOMESTORE INC - Form 10-Q

Total	<u>\$65,171</u>	<u>\$45,845</u>	<u>\$65,171</u>	<u>\$39,413</u>
-------	-----------------	-----------------	-----------------	-----------------

---

As part of the reclassification of the WyldFyre business as discontinued operations, the Company has reclassified the unamortized goodwill associated with WyldFyre as part of the Assets of discontinued operations. The total unamortized balance as of September 30, 2004 and December 31, 2003 was approximately \$1.0 million.

In the third quarter of 2003, specific events and changes in operations of the Company's business indicated a potential impairment of its long-lived assets. The specific events and changes in circumstances indicating a potential impairment included certain business units continuing to perform below management's expectations. Pursuant to SFAS No. 144 and SFAS No. 142, Goodwill and Other Intangible Assets, the Company performed an impairment analysis. Fair value was determined based on the present value of estimated expected cash flows using discount rates ranging from 11% to 20%. The Company's impairment analysis resulted in a charge of \$15.7 million in the quarter ended September 30, 2003 comprised of impairments of \$11.8 million of identifiable intangible assets relating to the Company's acquisition of its apartments and rentals business, \$2.6 million of intangibles and goodwill and property and equipment relating to the acquisition of Computers for Tracts and \$1.3 million of prepaid distribution expense.

In conjunction with the settlement of the dispute with Cendant Corporation and certain of its affiliates (collectively Cendant) (see Note 12), the Company relinquished certain exclusive data rights and rights under other agreements that were entered into at the time of the acquisition of Move.com, Inc. and Welcome Wagon International, Inc. (collectively referred to as the Move.com Group). As a result of the surrender of those rights, certain intangible assets associated with those rights no longer had value to the Company, and, accordingly, the Company recorded an impairment charge of \$12.2 million in the nine months ended September 30, 2003.

Amortization expense for intangible assets for the three and nine months ended September 30, 2004 was \$2.0 million and \$6.4 million, respectively. Amortization expense for the next five years is estimated to be as follows (in thousands):

<b>Years Ended December 31,</b>	<b>Amount</b>
2004 (remaining three months)	\$ 1,462
2005	3,588
2006	1,834
2007	1,424
2008	1,424

## **8. Related Party Transactions**

In February 2001, the Company acquired all of the outstanding shares of the Move.com Group from Cendant, valued at \$745.7 million. In connection with the Company's acquisition of the Move.com Group, Cendant alleged that the Company may have breached certain representations and warranties made in the acquisition agreement as a result of the restatement of the Company's 2000 financial statements (see Note 12).

In connection with and contingent upon the closing of the acquisition of the Move.com Group, the Company entered into a series of commercial agreements for the sale of various technology and subscription-based products to Real Estate Technology Trust (RETT), an independent trust established in 1996 to provide technology services and products to Cendant's real estate franchisees that was considered a related party of the Company until January 2004. Under the commercial agreements, RETT committed to purchase \$75.0 million in products and services to be delivered to agents, brokers and other Cendant real estate franchisees over the next three years. Subsequent to the closing of the acquisition of the Move.com Group, the Company entered into additional commercial agreements with Cendant and RETT. Each of Cendant and RETT ceased to be a related party of the Company in January 2004.

Revenue of \$1.3 million related to these transactions was recognized in the three months ended September 30, 2003 and revenue of \$5.8 million related to these transactions was recognized in the nine months ended September 30, 2003. Revenue related to these transactions is no longer reflected separately in the unaudited Consolidated Statement of Operations as they are no longer related parties. It is not practical to separately determine the costs of such revenues.

## **9. Stock-Based Charges**

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board ( APB ) No. 25, Accounting for Stock Issued to Employees ( APB No. 25 ), and complies with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS No. 123 ). Under APB No. 25, compensation expense is recognized over the vesting period based on the difference, if any, on the date of grant between the deemed fair value for accounting purposes of the Company's stock and the exercise price on the date of grant. The Company accounts for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ( EITF ) No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods and Services.

The following chart summarizes the stock-based charges that have been included in the following captions for each of the periods presented (in thousands):

---

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Revenue	\$	\$373	\$	\$1,119
Cost of revenue				16
Sales and marketing	75	446	226	3,719
Product and website development				15
General and administrative	59	29	459	135
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
	\$134	\$848	\$685	\$5,004
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>

Stock-based charges for the three and nine months ended September 30, 2004 consist of \$0.1 million and \$0.2 million, respectively, related to vendor agreements with the remainder related to the amortization of restricted stock.

#### 10. Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share for the periods indicated (in thousands, except per share amounts):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Numerator:				
Loss from continuing operations	\$ (4,615)	\$ (30,892)	\$ (13,111)	\$ (37,430)
Gain on disposition of discontinued operations				2,530
Income (loss) from discontinued operations	42	310	(807)	(167)
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
Net loss	\$ (4,573)	\$ (30,582)	\$ (13,918)	\$ (35,067)
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>
Denominator:				
Basic and diluted weighted average shares outstanding	145,823	119,418	133,226	118,566
	<u>      </u>	<u>      </u>	<u>      </u>	<u>      </u>

Basic and diluted income (loss) per share:				
Continuing operations	\$ (0.03)	\$ (0.26)	\$ (0.10)	\$ (0.32)
Discontinued operations	0.00	0.00	(0.01)	0.02
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	\$ (0.03)	\$ (0.26)	\$ (0.10)	\$ (0.30)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

The per share computations exclude preferred stock, options and warrants that are anti-dilutive. The number of shares excluded from the basic and diluted net loss per share computations were 27,177,611 for the three and nine months ended September 30, 2004, and 22,619,700 for the three and nine months ended September 30, 2003.

## 11. Segment Information

Segment information is presented in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating expenses based upon internal accounting methods. The Company's management evaluates performance and allocates resources based on three segments consisting of Media Services, Software and Print.

The expenses presented below for each of the business segments include an allocation of certain corporate expenses that are identifiable and benefit those segments and are allocated for internal management reporting purposes. The unallocated expenses are those corporate overhead expenses that are not directly attributable to a segment and include: corporate expenses, such as finance, legal, internal business systems, and human resources; amortization of intangible assets; litigation settlement charges; impairment charges; stock-based charges; and restructuring charges. There is no inter-segment revenue. Assets and liabilities are not fully allocated to segments for internal reporting purposes.



Summarized information, by segment, as excerpted from the internal management reports is as follows (excluding discontinued operations) (in thousands):

**Three Months Ended**

	<b>September 30, 2004</b>					<b>September 30, 2003</b>				
	<b>Media</b>	<b>Software</b>	<b>Print</b>	<b>Unallocated</b>	<b>Total</b>	<b>Media</b>	<b>Software</b>	<b>Print</b>	<b>Unallocated</b>	<b>Total</b>
Revenue	\$37,151	\$5,838	\$13,092	\$	\$56,081	\$35,475	\$4,967	\$12,482	\$	\$ 52,924
Cost of revenue	6,010	1,849	5,053	205	13,117	7,630	2,194	4,852	330	15,006
Gross profit (loss)	31,141	3,989	8,039	(205)	42,964	27,845	2,773	7,630	(330)	37,918
Sales and marketing	15,024	1,260	5,123	166	21,573	17,987	1,398	5,061	1,176	25,622
Product and website development	2,565	1,578	61	25	4,229	2,707	1,674	90	2	4,473
General and administrative	5,157	838	2,488	14,012	22,495	4,802	680	2,451	8,754	16,687
Amortization of intangible assets				1,990	1,990				5,935	5,935
Litigation settlement										
Impairment of long-lived assets									15,664	15,664
Total operating expenses	22,746	3,676	7,672	16,193	50,287	25,496	3,752	7,602	31,531	68,381
Income (loss) from operations	\$ 8,395	\$ 313	\$ 367	\$ (16,398)	\$ (7,323)	\$ 2,349	\$ (979)	\$ 28	\$ (31,861)	\$ (30,463)

**Nine Months Ended**

	<b>September 30, 2004</b>					<b>September 30, 2003</b>				
--	---------------------------	--	--	--	--	---------------------------	--	--	--	--

Edgar Filing: HOMESTORE INC - Form 10-Q

	<u>Media</u>	<u>Software</u>	<u>Print</u>	<u>Unallocated</u>	<u>Total</u>	<u>Media</u>	<u>Software</u>	<u>Print</u>	<u>Unallocated</u>	<u>Total</u>
Revenue	\$ 112,490	\$ 17,117	\$ 36,804	\$	\$ 166,411	\$ 107,002	\$ 15,308	\$ 35,837	\$	\$ 158,147
Cost of revenue	<u>18,941</u>	<u>5,410</u>	<u>14,785</u>	<u>629</u>	<u>39,765</u>	<u>23,051</u>	<u>5,858</u>	<u>14,656</u>	<u>1,122</u>	<u>44,687</u>
Gross profit (loss)	93,549	11,707	22,019	(629)	126,646	83,951	9,450	21,181	(1,122)	113,460
Sales and marketing	49,827	4,073	14,577	521	68,998	51,973	5,808	14,264	5,782	77,827
Product and website development	7,824	4,629	181	2	12,636	8,719	5,223	359	19	14,320
General and administrative	14,447	2,385	7,439	27,562	51,833	18,287	2,545	7,790	23,357	51,979
Amortization of intangible assets				6,432	6,432				19,874	19,874
Litigation settlement				2,168	2,168				63,600	63,600
Impairment of long-lived assets									27,822	27,822
Restructuring charges				<u>345</u>	<u>345</u>					
Total operating expenses	<u>72,098</u>	<u>11,087</u>	<u>22,197</u>	<u>37,030</u>	<u>142,412</u>	<u>78,979</u>	<u>13,576</u>	<u>22,413</u>	<u>140,454</u>	<u>255,422</u>
Income (loss) from operations	<u>\$ 21,451</u>	<u>\$ 620</u>	<u>\$ (178)</u>	<u>\$(37,659)</u>	<u>\$(15,766)</u>	<u>\$ 4,972</u>	<u>\$(4,126)</u>	<u>\$(1,232)</u>	<u>\$(141,576)</u>	<u>\$(141,962)</u>

## 12. Settlement of Disputes and Litigation

### *Settlement of AOL Dispute*

In January 2003, the Company entered into a marketing agreement with America Online, Inc. ( AOL ) that resolved its dispute with AOL and terminated obligations under a prior marketing agreement. Under the January 2003 marketing agreement, the Company maintained the exclusive right to provide AOL with real estate listings, and AOL members retained access to a wide array of the Company's professional content. The Company paid AOL \$7.5 million in cash to terminate the previous agreement and allowed AOL to fully draw down on an existing \$90.0 million letter of credit secured by restricted cash on the Company's Consolidated Balance Sheet at December 31, 2002. Termination of the previous agreement also eliminated the Company's responsibility to provide AOL with an additional make-whole payment in July 2003, which would have been approximately \$57.0 million, payable in cash or stock. Transfer restrictions relating to the approximately 3.9 million shares of the Company's common stock issued to AOL under the previous agreement were also removed. Over the term of the agreement, the Company made quarterly cash payments of \$3.75 million, in six equal installments which began in January 2003 and ended in April 2004.

In connection with the settlement with AOL, the Company reduced its accrued distribution obligation and accrued expenses by \$189.9 million and \$4.2 million, respectively, and allowed AOL to draw down on the \$90.0 million letter of credit. Accordingly, the Company recorded a gain on settlement of the distribution agreement of \$104.1 million, which is included as gain on settlement of distribution agreement in the Consolidated Statement of Operations for the nine months ended September 30, 2003.

The January 2003 marketing agreement expired on June 30, 2004, and was replaced with an agreement that extends through December 31, 2005.

### *Settlement of Securities Class Action Lawsuit*

Beginning in December 2001, numerous separate complaints purporting to be class actions were filed in various jurisdictions alleging that the Company and certain of its current and former officers and directors violated certain provisions of the Securities Exchange Act of 1934. The complaints contain varying allegations, including that the Company made materially false and misleading statements with respect to the Company's 2000 and 2001 financial results included in the Company's filings with the SEC, analysts reports, press releases and media reports. The complaints sought an unspecified amount of damages. In March 2002, the California State Teachers' Retirement System was named lead plaintiff (the Plaintiff ), and the complaints were consolidated in the United States District Court, Central District of California. In July 2002, the Plaintiff filed a consolidated amended class action complaint naming the Company, certain of the Company's former officers, directors and employees, along with PricewaterhouseCoopers LLP as defendants. In November 2002, the Plaintiff filed a first amended consolidated class action complaint ( Securities Class Action Lawsuit ) naming the Company, certain of its current officers, directors and employees, certain of the Company's former officers, directors and employees, and various other parties, including, among others, PricewaterhouseCoopers LLP, as defendants. The amended complaint made various allegations, including that the Company violated federal securities laws, and sought an unspecified amount of damages.

On March 7, 2003, the court dismissed, with prejudice, the Plaintiff's claims against a number of corporate and individual defendants whom the Plaintiff alleged either assisted in the planning and execution of the purportedly fraudulent transactions at issue, or who were parties to those transactions. The court also dismissed without prejudice the Plaintiff's claims against a number of the Company's current and former officers and employees. At the same time, the court denied the motions to dismiss of PricewaterhouseCoopers LLP and the Company's former chief executive officer. The Company did not file a motion to dismiss the Plaintiff's claims against the Company, but answered the complaint. Accordingly, the March 7, 2003 decision did not make any ruling with respect to the claims asserted

against the Company.

On August 12, 2003, the Company entered into a settlement agreement with the Plaintiff to resolve all outstanding claims related to the Securities Class Action Lawsuit. On October 8, 2003, the District Court preliminarily approved the settlement. A final hearing on the settlement was held on January 16, 2004, after delivery of notice to class members. On February 5, 2004, the Court issued an interim order generally approving the terms of the settlement as fair, adequate and reasonable, but directing additional briefing on two issues: (1) whether certain objectors' proposal to carve out certain claims from the settlement is feasible; and (2) whether notice to class members was potentially inadequate because of the short time period given to file their claims. The Court suggested that the parties consider allowing additional time for class members to file claims, which would not affect the total settlement fund. On March 16, 2004, the Court issued its Order Granting Motion for Final Approval of Partial Class Settlement and Directing Renotice of the Class. The Order directed that an abbreviated class notice be published and extended the deadline for class members to opt out or submit claims until May 31, 2004. On May 14, 2004, the District Court entered final judgment and an order of dismissal with prejudice as to the Company. The final judgment includes a bar order providing for the maximum protection to which the Company is entitled under the law with respect to all future claims for contribution or indemnity by other persons, whether under federal, state or common law. On June 10, 2004, an objector to the settlement filed a notice of appeal. In his appeal, the objector has raised deficiencies in the notice program for providing notice to class members of the class settlement.

As a part of the settlement, the Company agreed to pay \$13.0 million in cash and issue 20.0 million new shares of the Company's common stock valued at \$50.6 million as of August 12, 2003. The Company placed \$10.0 million in escrow in October 2003 and an additional \$3.0 million in escrow in April 2004. In May 2004, in accordance with an order entered by the District Court, the Company issued the 20.0 million shares to counsel to the Plaintiff as trustee. The shares must be voted in proportion to the votes of all the other

---

holders of the Company's common stock who exercise their voting rights at a stockholder meeting or by written consent in lieu of a meeting until such time as they are distributed to the class. The issuance of the shares was exempt from registration under Section 3(a)(10) of the Securities Act of 1933. Assuming the District Court's final judgment is upheld on appeal, the \$13.0 million and the 20.0 million shares will be distributed to the class and Plaintiff's counsel in accordance with the judgment. The 20.0 million shares currently held in trust have been reflected as issued and outstanding in the Company's financial statements beginning in May 2004.

The Company expects that the settlement will be upheld on appeal, although there can be no assurance of this. If the settlement is not upheld, the Company will incur significant additional expense in connection with the Securities Class Action Lawsuit that could have material adverse effect on its financial condition.

As a result of the settlement, the Company recorded a litigation settlement charge of \$63.6 million in its operating results in the nine months ended September 30, 2003. In addition, the Company agreed to adopt, within thirty days of final judicial approval of the settlement, certain corporate governance principles that have been approved by the Board of Directors, including requirements for independent directors and special committees, a non-classified Board of Directors with two-year terms, appointment of a new shareholder-nominated director, prohibition on the future use of stock options for director compensation and minimum stock retention by officers after exercise of future stock option grants. The Company will also divide equally with the class any future net proceeds from insurance with respect to the litigation after provision for legal expenses incurred against the Company. The Plaintiff has agreed that any members of the class who participate in the settlement will release and discharge all claims against the Company. The Company is aware that several persons, who purportedly acquired the Company's shares during the class period during January 1, 2000 through December 21, 2002, representing approximately 1% of our outstanding shares, have notified the Plaintiff that they wish to be excluded from the settlement.

There are still additional risks to the Company related to the Securities Class Action Lawsuit. These risks include the pending appeal of the United States District Court's order approving the settlement and litigation by persons who have elected to be excluded from the settlement or whose claims against the Company may not be discharged or barred by the settlement.

### ***Settlement of Cendant Dispute***

In connection with the Company's acquisition of the Move.com Group, the Company entered into a series of agreements with Cendant that, among other things, provided the Company with certain promotion and exclusive data rights and placed certain restrictions on Cendant's ability to dispose of the Company's shares. In connection with the Company's acquisition of the Move.com Group, Cendant previously alleged that the Company breached certain representations and warranties made in the acquisition agreement as a result of the restatement of the Company's Condensed Consolidated Financial Statements for the year ended December 31, 2000 and the first three quarters of 2001. On August 5, 2003, the Company and Cendant settled potential claims relating to the Company's acquisition of the Move.com Group and entered into certain new agreements with Cendant. The settlement terminated certain existing arrangements between the Company and Cendant and resulted in several new arrangements between the parties.

*Settlement Agreement.* Under the terms of the settlement agreement, Cendant agreed not to sue the Company or its officers, directors and other related parties with respect to the acquisition of the Move.com Group and the prior restatement of the Company's Condensed Consolidated Financial Statements. However, in the circumstances described below, Cendant retains the right to sue the Company for contribution, indemnification, or similar relief if Cendant is held liable for or settles claims against it in the Securities Class Action Lawsuit up to the amount for which it is held liable or for which it settles.

On March 7, 2003, the court in the Securities Class Action Lawsuit dismissed with prejudice Cendant as a defendant. However, that dismissal has been appealed to the United States Court of Appeals for the Ninth Circuit. In October 2004, the Securities and Exchange Commission filed an amicus brief in support of the appeal. If Cendant's dismissal as a defendant in the Securities Class Action Lawsuit is reversed on appeal and Cendant is subsequently found liable or settles the claims against it in the Securities Class Action Lawsuit, Cendant will likely seek indemnification, contribution or similar relief from the Company. However, on March 16, 2004, as part of the Company's settlement of the Securities Class Action Lawsuit, the United States District Court issued an order approving the settlement and barring claims by third parties against the Company for indemnification, contribution and similar relief with respect to liability such third parties may have in the Securities Class Action Lawsuit.

The March 16, 2004 order may preclude Cendant from seeking indemnification, contribution or similar relief from the Company in the event Cendant is found liable or settles claims against it in the Securities Class Action Lawsuit. However, the Company has been advised by counsel that the law is unclear on whether Cendant would be so precluded. Therefore, the Company would likely incur significant expenses in defending such an action by Cendant and could ultimately be found liable to Cendant or settle with Cendant, notwithstanding the bar order. Such expenses, liability or settlement could have a material adverse effect on the Company's financial position and results of operations.

In addition, if Cendant is not permitted to share in the settlement of the Securities Class Action Lawsuit (which would be the case if its dismissal as a defendant is reversed on appeal), the Company has agreed to pay or otherwise provide to Cendant the amount of money and/or other consideration that Cendant would have been otherwise entitled to receive from that portion of the class action settlement fund provided by the Company had Cendant been a class member and Cendant's proof of claim in respect of its shares had been accepted in full. At this time, Cendant is still a member of the class action and has not been excluded. Pending resolution of the appeal and approval by the District Court of the distribution to the class of the cash held in escrow and shares held in trust, the Company is unable to estimate the amount of cash and number of shares that Cendant could be entitled to receive from the Company should Cendant be prevented from participating in the settlement.

---

For its part, the Company released all claims against Cendant (including a release of any derivative claims, to the extent permitted by law) relating to the acquisition of the Move.com Group and the Company's prior restatement of its Condensed Consolidated Financial Statements.

The settlement agreement also provided for the termination of a stockholders agreement that contained a standstill provision under which Cendant had agreed not to acquire additional Homestore stock, a requirement that Cendant vote its Homestore stock in proportion to the vote of all other stockholders and restrictions on Cendant's ability to sell its Homestore stock. On August 14, 2003, the Company filed a registration statement to enable Cendant and its affiliates to sell their shares of the Company's common stock to the public.

In addition to the settlement agreement, Cendant and the Company executed an Option Agreement, a new Listings License Agreement and a Source Code License and Maintenance Services Agreement.

### ***Settlement of Derivative Litigation***

In January 2002, Robert Sparaco (Sparaco) filed a complaint in California Superior Court, Los Angeles County, derivatively on the Company's behalf as nominal defendant, against certain of the Company's current and former officers and directors. Two additional shareholder derivative actions were filed against substantially the same defendants on the Company's behalf as nominal defendant. The three derivative actions allege breaches of fiduciary duty, negligence, abuse of control, misconduct, waste of corporate assets and other violations of state law. In March 2002, the court entered an order consolidating the three actions. In November 2002, the plaintiffs filed a first-amended consolidated shareholder derivative complaint. The complaint sought an unspecified amount of damages.

In January 2002, Jeff Joerg (Joerg) filed a complaint in Delaware Chancery Court, derivatively on the Company's behalf as nominal defendant, against certain of the Company's current and former officers and directors. The complaint alleges that defendants breached their fiduciary duties by failing to maintain adequate accounting controls and by employing improper accounting practices and procedures. The complaint sought an unspecified amount of damages.

On January 28, 2004, the Company entered into a settlement to resolve the California Superior Court (Sparaco) and Delaware Chancery Court (Joerg) derivative actions. In consideration for plaintiffs' release of all claims, the Company agreed: to adopt the corporate governance reforms set forth in the Securities Class Action Lawsuit settlement upon final judicial approval of the settlement, that it was in the best interests of the Company to terminate its relationship with PricewaterhouseCoopers LLP as the Company's auditors (which the Audit Committee did in September 2003); and to pay plaintiffs' attorneys' fees in the sum of \$150,000 in cash and 200,000 shares of the Company's stock. The conditions of the settlement include approval by the United States District Court of the Securities Class Action Lawsuit settlement, approval by the California Superior Court of the consolidated shareholder derivative action settlement and the dismissal with prejudice of the California and Delaware actions. On March 16, 2004, the United States District Court issued an order approving the Securities Class Action settlement, and on March 26, 2004, the Superior Court approved the consolidated shareholder derivative settlement. In May 2004, the Company paid these fees, and issued the 200,000 shares of common stock in a transaction exempt from registration by Section 3(a)(10) of the Securities Act of 1933. The Company had previously accrued for the expense of the settlement.

### ***Settlement of Other Securities Litigation***

On June 7, 2004, the Company entered into an agreement providing for the settlement of three lawsuits brought against it by certain former shareholders of Top Producer Systems, Inc. (Top Producer) in connection with the acquisition of Top Producer in May 2000. Pursuant to this settlement, on July 6, 2004, the Company (i) issued 2,097,984 shares of common stock in satisfaction of the remaining installments of the Company's purchase price of

Top Producer that were due in 2003, 2004 and 2005, (ii) issued 151,064 shares of common stock and paid \$104,000 in cash in satisfaction of non-competition payments due to the former president of Top Producer, and (iii) issued an additional 75,988 shares of common stock in settlement of the various claims. Issuance of the shares was exempt from registration under Section 3(a)(10) of the Securities Act of 1933. As a result of the acceleration of the remaining installments of the purchase price and the issuance of additional stock to settle this dispute, the Company recorded a litigation settlement charge of \$793,000 in the nine months ended September 30, 2004.

On July 6, 2004, the Company settled a lawsuit brought against it by certain former owners and directors of iPlace. Pursuant to this settlement, on July 9, 2004, the Company issued to the plaintiffs 177,631 shares of the Company's common stock and paid \$700,000 in cash. The issuance of the shares in the settlement was exempt from registration under Section 3(a)(10) of the Securities Act of 1933. As a result of the settlement, the Company recorded a litigation settlement charge of approximately \$1.4 million in the nine months ended September 30, 2004.

### **13. Commitments and Contingencies**

#### ***Contingencies Under Litigation Settlements***

See Note 12, Settlement of Disputes and Litigation Settlement of Securities Class Action Lawsuit, for contingencies related to the settlement of the Class Action Lawsuit and Note 12 Settlement of Disputes and Litigation Settlement of Cendant Dispute for contingencies related to the settlement with Cendant.

---



### ***Contingencies Related to Pending Litigation***

In September 2002, Matt L. Brody ( Brody ) filed a purported class action complaint in Superior Court for the State of California, Los Angeles County against the Company, certain of its former officers and certain current and former directors, and certain underwriters, purporting to state claims under Sections 11, 12(a)(2) and 15 of the Exchange Act, alleging that the Company's January 26, 2000, registration statement contained materially false and misleading statements. The complaint seeks rescission or an unspecified amount of damages. In October 2002, defendants removed the action to the United States District Court for the Central District of California. In June 2003, Brody filed a petition with the United States Court of Appeals for the Ninth Circuit asking the Ninth Circuit to direct the District Court to vacate its order denying Brody's motion to remand the action to state court. The Ninth Circuit heard oral arguments on the petition on July 14, 2004, denied the petition by order filed on August 17, 2004, and denied Brody's subsequent petition for rehearing by order filed on September 28, 2004.

On August 11, 2003, the District Court issued an order dismissing (without prejudice) Brody's claims and striking his class action allegations. Brody filed an amended complaint on September 12, 2003. The Company filed a motion to dismiss the amended complaint and to strike the class allegations with prejudice. Separately, Brody's counsel filed a motion to amend Brody's complaint to add Ronald Drucker ( Drucker ) as a plaintiff. Brody filed a motion to stay his District Court lawsuit pending final resolution of the Securities Class Action. On July 13, 2004, the Court denied Brody's motion to stay and by Order Granting Motion to Dismiss, filed August 11, 2004, the District Court dismissed all causes of action against all defendants. On September 2, 2004, Brody filed a notice of appeal from dismissal of the lawsuit.

Drucker, separately, filed a motion in the Securities Class Action requesting that the class purportedly represented by Brody and Drucker be carved out of the settlement of the Securities Class Action. On March 16, 2004, the Court issued an order approving the Securities Class Action settlement and determining that the Brody and Drucker claims would not be carved out (See Note 12).

In November 2002, Gregory C. Pyfrom ( Pyfrom ) filed a complaint in Superior Court for the State of California, Ventura County against the Company and certain of its former officers and directors, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5 there under, as well as intentional fraud, negligent misrepresentation, breach of fiduciary duty, breach of the covenant of good faith and fair dealing, violations of various other laws and negligent and intentional infliction of emotional distress. The Complaint has been amended several times. The Company answered the Third Amended Complaint, which seeks an unspecified amount of general, exemplary and punitive damages.

The Court concluded a scheduling conference in the Pyfrom action on June 28, 2004, following which the Court continued the existing stay on discovery, and set a further status conference for September 27, 2004. Pyfrom is a class member in the Securities Class Action Lawsuit and did not opt out of the settlement of that action. The Company filed a motion for judgment on the pleadings or in the alternative for a summary judgment on the principal ground that, under the law, his lawsuit should be dismissed because his claims are barred by the final judgment entered in the Securities Class Action. By Order entered on October 20, 2004, the Court granted the Company's motion for summary judgment in its favor as to all claims.

On March 30, 2004, three shareholders of WyldFyre Technologies, Inc. ( WyldFyre ), two of whom had previously opted out of the settlement of the Securities Class Action Lawsuit, filed a complaint in the Superior Court of California, County of Los Angeles against the Company, two of its former officers and Merrill Lynch & Co., Inc. The complaint alleges fraud, negligent misrepresentation, vicarious liability, unfair business practices, unjust enrichment and breach of contract arising out of the Company's acquisition of WyldFyre in March 2000. The complaint seeks restitution, rescissory or compensatory damages, disgorgement of benefits, punitive damages and costs of

litigation. The Company intends to vigorously defend this action. At this time, however, the Company is unable to express an opinion on the outcome of this case.

### ***SEC Investigation***

In January 2002, the Company was notified that the SEC had issued a formal order of private investigation in connection with accounting matters that resulted in the restatement of the Company's financial results in March 2002. The SEC requested that the Company provide it with certain documents concerning the restatement. The SEC has also requested access to certain of the Company's current and former employees for interviews. The Company has cooperated and continues to cooperate fully with the SEC's investigation.

Since September 2002, certain of the Company's former employees have entered into plea agreements with the United States Attorney's Office and the SEC in connection with the investigation. Also in September 2002, the SEC and the Department of Justice (DOJ) informed the Company that in light of the actions taken by the Company's Board of Directors and the Company's Audit Committee and its cooperation in the SEC's investigation those agencies would not bring any enforcement action against the Company. Because the SEC and DOJ investigations are ongoing and the Company is committed to cooperating with those investigations, the Company will likely continue to incur additional costs related to the investigation, and management time and attention may be diverted until the investigation concludes.

### ***Insurance Coverage Litigation***

Between September 2002 and November 2002, Genesis Insurance Company (Genesis), Federal Insurance Company (Federal), Clarendon National Insurance Company (Clarendon), Royal Indemnity Company (Royal) and TIG Insurance Company of Michigan (TIG) sent the Company notices of rescission of the officers and directors liability policies issued to the Company for the

---

period of August 4, 2001 through August 4, 2002. The same carriers filed complaints to judicially confirm the rescissions or for declaratory relief in the United States District Court, Central District of California against the Company and certain of its current and former officers, directors and employees. The complaints allege misrepresentations contained in the original applications for insurance, the renewal applications and warranty letters. The Company had requested that the court stay the Federal and Genesis actions, but those requests were denied in March 2003.

In October 2002, Lumbermens Mutual Casualty Company ( Lumbermens ) rescinded and filed a similar complaint against the Company and certain of its current and former officers, directors and employees to confirm the rescission in the Superior Court of California, County of Los Angeles.

In February 2003, TIG dismissed its federal court rescission action and filed a new rescission action against the Company and certain of the Company's current and former officers and directors in California State Superior Court.

In May 2003, XL Insurance Limited ( Bermuda ) sent the Company a notice of rescission of the officers and directors liability policy issued to the Company for the period August 4, 2001 to August 4, 2002. The Company is in discussions with Bermuda about possibly deferring any arbitration over the insurer's purported rescission pending the resolution of the underlying liability lawsuits.

In May 2003, the United States District Court for the Central District of California denied the Company's request that the hearing on Federal's motion for summary judgment be continued to allow the Company to conduct discovery on the issues presented by Federal's motion, and granted Federal's motion for summary judgment declaring that the directors and officers liability policy issued by Federal is rescinded as to all insureds. In July 2003, the same Court granted motions for summary judgment declaring that the directors and officers liability policies issued by Genesis, Royal and Clarendon are rescinded as to all insureds.

On January 21, 2004, the Company filed briefs appealing each of the District Court's judgments to the Ninth Circuit Court of Appeals. A date for oral argument has not been scheduled.

On February 27, 2004, the California State Superior Court granted the TIG and Lumbermens' motions for summary judgment. On July 15, 2004, the Company filed a notice of appeal in both cases.

The Company is unable to express an opinion at this time as to the outcome of these lawsuits.

### ***Other Litigation***

In June 2000, Dr. Anil K. Agarwal filed a petition for declaratory judgment against the Company in the District Court of Douglas County, Nebraska. The lawsuit arises from a transaction between Dr. Agarwal and Michael K. Luther, in relation to which Mr. Luther directed InfoTouch Corporation ( InfoTouch ), the Company's predecessor, to transfer certain shares of InfoTouch Series B Preferred Stock to Dr. Agarwal. Dr. Agarwal seeks substantial damages and a declaratory judgment in connection with his claim that he should have been issued shares of Series B Preferred stock of InfoTouch sufficient to entitle him to receive 76,949 shares of common stock (on a pre-split basis), and that there is a shortfall of 46,950 shares, pre-split (or 104,375 shares of common stock, post-split) due and owing to him. The Company has filed a motion for summary judgment that was heard on September 21, 2004. Although the Company intends to defend this claim vigorously, the Company is unable to express an opinion at this time as to the outcome of this lawsuit.

In December 2001, Pentawave Inc. filed a suit for fraud, breach of contract and defamation in Ventura County Superior Court seeking \$5.0 million in compensatory and punitive damages. Although the Company intends to defend

this claim vigorously, the Company is unable to express an opinion as to the outcome of the litigation. No trial date is currently scheduled.

In June 2002, Tren Technologies Holdings LLC., ( Tren ) served a complaint on Homestore, NAR and NAHB in the United States District Court, Eastern District of Pennsylvania. The complaint alleged a claim for patent infringement based on activities related to the websites REALTOR.com® and HomeBuilder.com. Specifically, Tren alleged that it owns a patent (U.S. Patent No. 5,584,025) on an application, method and system for tracking demographic customer information, including tracking information related to real estate and real estate demographics information, and that the Company has developed an infringing technology for the NAR's REALTOR.com® and the NAHB's HomeBuilder.com websites. The complaint sought unspecified damages and a permanent injunction against the Company using the technology. On May 22, 2004, the Company filed with the United States Patent and Trademark Office ( USPTO ) a Request for Reexamination of the patent at issue in the action. On May 25, 2004, the Court issued an order dismissing the action without prejudice and stating that the matter is to remain status quo and that the statute of limitations is tolled, and further stating that the matter remains active and any discovery and settlement discussions will continue. On July 8, 2004, the USPTO granted the Request for Reexamination. The USPTO's ultimate decision in the reexamination proceeding is likely to have an impact on the outcome of the action. On September 8, 2004, a status conference was held in which the Court informed the parties to contact it after there has been further progress in the Reexamination hearing. The Company believes Tren's claims are without merit and intends to vigorously defend the case.

On October 1, 2003, Plaintiff Kevin Keithley ( Keithley ) filed a complaint against the Company, the NAR and the NAHB in the United States District Court for the Northern District of California alleging infringement of U. S. Patent No. 5,584,025 pursuant to 35 U.S.C. Section 271. The complaint sought unspecified damages and a permanent injunction against the Company using the technology. In the complaint, Keithley asserts exclusive license of the patent. After Keithley filed and served the complaint, defendants, including the Company, on May 24, 2004 filed an answer and counterclaims seeking declarations of non-infringement and invalidity of the patent at issue in the action. Keithley has answered the counterclaims. On May 22, 2004, the Company filed with the USPTO a Request for Reexamination of the patent at issue in the action. On July 8, 2004, the USPTO granted the Request for

---

Reexamination. The UPSTO's ultimate decision in the reexamination proceeding is likely to have an impact on the outcome of the action. The Court has stayed this action pending the Reexamination proceeding. The Company believes Keithley's claims are without merit and intends to vigorously defend the case.

On October 29, 2003, Peter Tafeen ( Tafeen ), a former officer of Homestore, filed suit in the Delaware Chancery Court in New Castle County. The complaint asserted a claim for advancement of fees and expenses already incurred and for future expenses to be incurred in connection with the SEC and Department of Justice investigations and the civil actions filed against Tafeen for his purported role in a scheme to inflate the Company's revenues. Tafeen and the Company filed cross-motions for summary judgment. On March 22, 2004, the Court issued a revised Memorandum of Opinion denying both summary judgment motions and directed the case go to trial. The trial concluded on July 27, 2004. On October 27, 2004, the Court ruled that the Company is obligated to advance to Tafeen all reasonable attorney's fees and costs associated with the various legal proceedings in which Tafeen is involved by reason of his service as an officer of the Company, as well as Tafeen's fees in prosecuting the action before the Court. The Company is analyzing the Court's ruling and considering its options, including a possible appeal of such decision. Accordingly, the Company is unable to express an opinion as to the outcome of this case at this time. Notwithstanding the possibility of the Company prevailing in any such appeal, as a result of the Court's ruling, the Company has determined that it should establish an accrual of \$7.2 million for its estimate of the potential advancement of legal costs of former officers and directors, including Tafeen. The Company will review the amount of the accrual each quarter and determine whether incremental adjustments to the accrual should be made.

On April 12, 2004, the U.S. Department of Labor Wage and Hour Division (the DOL ), commenced a preliminary investigation into the Company's compliance with the Fair Labor Standards Act with regard to job classifications. The DOL and the Company have negotiated a settlement in connection with the DOL's investigation pursuant to which the Company, without admitting liability, has agreed to (1) convert its account executives to non-exempt classifications effective October 11, 2004; and (2) make payments of approximately \$1.4 million to 434 current and former account executives for past overtime compensation. These payments were made in October 2004 and have been reflected as sales and marketing expenses for the three and nine months ended September 30, 2004.

On September 17, 2004, Elizabeth Hathaway filed a class action lawsuit in Los Angeles County Superior Court on behalf of herself and all current and former Account Executives employed by Homestore, alleging that the Company misclassified account executives as exempt from overtime wage requirements in violation of California law. Homestore intends to vigorously defend against Hathaway's claims. It is the Company's belief that the amounts paid under the DOL settlement would be applied to any similar claims made by Hathaway so as to offset amounts that might ultimately be awarded to the class.

On July 29, 2004, the Company received a copy of an amended complaint in *Stichting Pensioenfonds ABP v. AOL Time Warner. et. al.* in which the Company was named as a defendant. The case was originally filed in the U.S. District Court for the Southern District of New York in July 2003 against Time Warner (formerly, AOL Time Warner), current and former officers and directors of Time Warner and America Online, Inc. ( AOL ), and Time Warner's outside auditor, Ernst & Young, LLP, alleging that Time Warner and AOL made material misrepresentations and/or omissions of material fact in connection with the business of AOL both before and after the merger of AOL and Time Warner in violation of federal securities laws and constituting common law fraud and negligent misrepresentation. In adding the Company as a defendant, the plaintiff, a Dutch pension fund, alleges that the Company and four other third parties with whom AOL did business and who are also named as defendants, aided and abetted the alleged common law fraud and themselves engaged in common law fraud as part of a civil conspiracy. The allegations against the Company, which are based on the factual allegations in the first amended consolidated class action complaint and other filings in the Company's Securities Class Action Lawsuit, are that certain former officers of the Company knew of the alleged fraud at AOL and knowingly participated in and substantially assisted that alleged fraud by negotiating, structuring and participating in numerous triangular round trip transactions with AOL and others.

The plaintiff seeks an unspecified amount of compensatory and punitive damages. The Company intends to defend vigorously against this suit. The Company is unable to predict the outcome of this case or reasonably estimate a range of possible loss.

***Other Contingencies***

From time to time, the Company is party to various other litigation and administrative proceedings relating to claims arising from its operations in the ordinary course of business. As of the date of this Form 10-Q and except as set forth herein, the Company is not a party to any other litigation or administrative proceedings that management believes will have a material adverse effect on the Company's business, results of operations, financial condition or cash flows.

---

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

This Form 10-Q and the following Management's Discussion and Analysis of Financial Condition and Results of Operations include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. This Act provides a safe harbor for forward-looking statements to encourage companies to provide prospective information about themselves so long as they identify these statements as forward-looking and provide meaningful cautionary statements identifying important factors that could cause actual results to differ from the projected results. All statements other than statements of historical fact that we make in this Form 10-Q are forward-looking. In particular, the statements herein regarding industry prospects and our future consolidated results of operations or financial position are forward-looking statements. Forward-looking statements reflect our current expectations and are inherently uncertain. Our actual results may differ significantly from our expectations. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this Form 10-Q, as well as those discussed in our Annual Report on Form 10-K for the year ended December 31, 2003, and in other documents we file with the Securities and Exchange Commission, or SEC. This Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2003.

### ***Our History***

We were incorporated in 1993 under the name of InfoTouch Corporation with the objective of establishing an interactive network of real estate kiosks for consumers to search for homes. In 1996, we began to develop the technology to build and operate real estate related Internet sites. In 1996, we entered into a series of agreements with NAR and several investors and transferred technology and assets to a newly-formed subsidiary, which ultimately became RealSelect, Inc. RealSelect, Inc. in turn entered into a number of formation agreements with, and issued cash and common stock representing a 15% ownership interest in RealSelect, Inc. to, NAR in exchange for the rights to operate the REALTOR.com® website and pursue commercial opportunities relating to the listing of real estate on the Internet. Our initial operating activities primarily consisted of recruiting personnel, developing our website content and raising our initial capital and we began actively marketing our advertising products and services to real estate professionals in January 1997. We changed the corporate name to Homestore.com, Inc. in August 1999. We changed our name to Homestore, Inc. in May 2002.

In recent years, our company has faced a number of difficult challenges. After discovering accounting irregularities in late 2001, we restated our financial statements for 2000 and the first three quarters of 2001. In the wake of these accounting irregularities and subsequent restatements, we have faced:

numerous lawsuits, including a consolidated securities class action and derivative litigation;

an SEC investigation of the company and our accounting practices;

contractual disputes with our customers and partners;

limited financial resources and the need for cost reduction measures;

listing maintenance issues with The NASDAQ National Market; and

replacement of the former executive management team, some of whom have pled guilty to criminal charges.

We believe that we have addressed each of these challenges, while recognizing that many risks persist. See Item 1, Business Risk Factors, contained in Part I to our Annual Report on Form 10-K for the year ended December 31, 2003 for more information.

During this time of uncertainty, many of our customers and potential customers have expressed concerns about our ability to provide value-added products and services. At the same time, we have modified our product and service offerings and have introduced new pricing structures that we believe better reflect the value of our products and services. We believe that the changes in our products and service offerings have begun to be accepted by our customers, despite initial resistance by some.

We have implemented four restructurings during the last three years, the first of which was in the fourth quarter of 2001. These restructurings were designed to focus our business and to eliminate redundancies in our organization. We believe these restructurings were necessary to address both our product and service offerings and our cost structure.

### ***Our Business***

We have created an online service that is the leading consumer destination on the Internet for home and real estate-related information, products and media services, based on the number of visitors, time spent on the websites and number of property listings. We provide a wide variety of information and tools for consumers and are a leading supplier of online media and technology solutions for real estate industry professionals, advertisers and providers of home and real estate-related products and services.

To provide consumers with real estate listings, access to real estate professionals and other home and real estate-related information and resources, we have established relationships with key industry participants. These participants include real estate market leaders such as the National Association of REALTORS®, or NAR, the National Association of Home Builders, or NAHB, hundreds of Multiple Listing Services, or MLSs, the Manufactured Housing Institute, or MHI, and leading real estate franchisors, including the six

---



largest franchises, brokers, builders and apartment owners. Under our agreement with NAR, we operate NAR's official website, REALTOR.com®. Under our agreement with NAHB, we operate its new home listing website, HomeBuilder.com. Under our agreements with NAR, NAHB, and MHI, we receive preferential promotion in their marketing activities.

### ***Basis of Presentation***

Our unaudited Condensed Consolidated Financial Statements reflect the historical results of Homestore, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

### ***Acquisitions***

Shortly after going public in August 1999, we implemented a strategy of acquiring a number of companies with real estate-related products and services. Since August 2001, we have not made any acquisitions and are not pursuing an acquisition strategy at this time.

### ***Business Trends and Conditions***

In recent years, our business has been, and we expect will continue to be, influenced by a number of macroeconomic, industry-wide and product-specific trends and conditions:

*Market and economic conditions.* In recent years, the U.S. economy has experienced low interest rates, and a severe downturn in the equities markets. Against this backdrop, housing starts have remained strong, while the supply of apartment housing has generally exceeded demand. At the same time, our business model has shifted from a technology offering to a media model. The foregoing conditions have meant that home builders have not had to spend as much money on advertising, given the strong demand for new houses. Conversely, apartment owners have spent less on advertising, as they have sought to achieve cost savings during the difficult market for apartment owners. Both of these trends have impacted our ability to grow our business. The impact of the recent rise in interest rates on job creation, housing starts and other economic factors is difficult to gauge and creates uncertainty as to whether these trends will continue.

*Evolution of Our Product and Service Offerings and Pricing Structures.*

*Media Services segment:* Our Media Services segment evolved as a business providing Internet applications to real estate professionals. In recent years, it became apparent that our customers valued the media exposure that the Internet offered them, but not the actual technology that we were offering. Many of our customers objected to our proposition that they purchase our templated website product in order to gain access to our networks. In addition, we were charging a fixed price to all customers regardless of the market they operated in or the size of their business.

In 2003, we responded to our customers' needs and revamped our product offerings. We began to price our product based on the size of the market and the number of properties they displayed. For many of our customers this change led to substantial price increases over our former technology pricing. This change has been reasonably well-accepted by our customers, however it has caused us to lose some customers. While we do not expect this trend to continue, if it were to continue, it could materially and adversely impact our Media Services segment revenue.

*Software segment:* In our Software segment, our largest business, Top Producer, introduced a monthly subscription model of an online application in late 2002. This had a negative impact on our revenues over the first eighteen months of this offering as we attempted to build the subscriber base. While our desktop product is still attractive to some real estate professionals, our customer base continues to shift to the online application and we believe it will completely replace our desktop product over the next year. We recently sold our Wyldfyre business that had been a part of this

segment and have reclassified the results of this business as discontinued operations for all periods presented.

*Print segment:* The downturn in the economy over the past three years has had an adverse effect on our Welcome Wagon business. Our primary customers are small local merchants trying to reach new movers and economic conditions have negatively impacted the small businesses more than other businesses. These economic conditions have caused a significant decline in our revenue in this segment over the past two years. Although we are starting to see some improvement in market conditions in some geographic areas, it could take considerable time before this segment yields meaningful growth, if at all.

Because of the limited resources we have available, we have instituted a staged investment strategy. Starting in mid-2002, we began conceiving and executing the repositioning of REALTOR.com®, Top Producer and Retail advertising activities. Our improved performance is entirely related to the improvement in those three businesses, which, in turn, gives us increasing confidence in the longer term results that we should be able to generate from our current and planned investments in other areas of our business. We are now focusing on investing in and improving our RentNet, HomeBuilder and Welcome Wagon businesses and expect to continue to do so through the remainder of 2004 and much of 2005. We believe that HomeBuilder and RentNet will begin contributing to our overall growth in the second half of 2005. The process of integrating Welcome Wagon into our Media Services businesses will require patience, but could represent a very large market opportunity for us.

***Critical Accounting Policies***

---

Our discussion and analysis of our financial condition and results of operations is based upon our unaudited Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these unaudited Condensed Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, uncollectible receivables, intangible and other long-lived assets and contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. This Form 10-Q should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2003.

***Legal Contingencies***

We are currently involved in certain legal proceedings, as discussed in Note 12, Settlement of Disputes and Litigation, and Note 13, Commitments and Contingencies, to our unaudited Condensed Consolidated Financial Statements. Because of the uncertainties related to both the amount and range of loss on the remaining pending litigation, we are unable to make a reasonable estimate of the liability that could result from one or more unfavorable outcomes. As additional information becomes available, we will assess the potential liability related to our pending litigation and revise our estimates. Such revisions in our estimates of the potential liability could materially impact our consolidated financial position and results of operations.

---

## ***Results of Operations***

### ***Three Months Ended September 30, 2004 and 2003***

#### ***Revenue and Related Party Revenue***

Revenue increased approximately \$3.2 million, or 6%, to \$56.1 million for the three months ended September 30, 2004 from \$52.9 million for the three months ended September 30, 2003. The primary reasons for the increase in revenue were increases in the Media Services segment of \$1.7 million, the Software segment of \$0.9 million and the Print segment of \$0.6 million. See the discussion of each segment's results below.

#### ***Cost of Revenue***

Cost of revenue decreased approximately \$1.9 million, or 13%, to \$13.1 million for the three months ended September 30, 2004 from \$15.0 million for the three months ended September 30, 2003. The decrease was primarily due to reductions in royalty expense of \$1.8 million and other cost reductions of \$0.1 million.

Gross margin percentage increased to 77% for the three months ended September 30, 2004 compared to 72% for the three months ended September 30, 2003. This improvement in gross margin percentage was primarily due to the factors noted above.

#### ***Operating Expenses***

***Sales and marketing.*** Sales and marketing expenses, including non-cash stock-based charges, decreased approximately \$4.0 million, or 16%, to \$21.6 million for the three months ended September 30, 2004 from \$25.6 million for the three months ended September 30, 2003. The decrease was primarily due to reductions related to our new online marketing agreements of \$2.1 million and a reduction in stock based charges of \$0.4 million due to the expiration of previous marketing agreements, and other cost reductions of \$1.5 million.

***Product and website development.*** Product and website development expenses decreased approximately \$0.3 million, or 7%, to \$4.2 million for the three months ended September 30, 2004 from \$4.5 million for the three months ended September 30, 2003 primarily due to a decrease in personnel related costs due to our restructuring efforts.

***General and administrative.*** General and administrative expenses, including non-cash stock-based charges, increased approximately \$5.8 million, or 35%, to \$22.5 million for the three months ended September 30, 2004 from \$16.7 million for the three months ended September 30, 2003. The increase was primarily due to our accrual of \$7.2 million for the potential advancement of legal costs of former officers and directors and increases in legal and accounting fees and consulting expenses of \$0.3 million primarily due to the costs of complying with Section 404 of the Sarbanes-Oxley Act of 2002. These increases were offset by decreases in personnel related costs of \$1.0 million due to our restructuring efforts and a \$0.7 million reduction in bad debt expense due to improved collections.

***Amortization of intangible assets.*** Amortization of intangible assets decreased approximately \$3.9 million, to \$2.0 million for the three months ended September 30, 2004 from \$5.9 million for the three months ended September 30, 2003. The decrease in amortization was primarily due to the impairment of intangible assets charged under Statement of Financial Accounting Standard ( SFAS ) No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets"( SFAS No. 144 ) and SFAS No. 142, "Goodwill and Other Intangible Assets"( SFAS No. 142 ), recorded in the quarter ended September 30, 2003 as well as certain intangible assets becoming fully amortized during 2004.

**Impairment of long-lived assets.** In conjunction with business units continuing to perform below our expectations, as required by SFAS Nos. 144 and 142, we performed an impairment analysis as of September 30, 2003. Our analysis resulted in a charge of \$15.7 million in the quarter ended September 30, 2003, comprised of impairments of \$11.8 million of identifiable intangible assets relating to our apartments and rentals business, \$2.6 million of intangibles, goodwill and property and equipment relating to the acquisition of Computers for Tracts and \$1.3 million of prepaid distribution expense.

**Restructuring charges.** There were no changes in estimates recorded for previous restructuring plans and no new restructuring plans were approved during the three months ended September 30, 2004 or September 30, 2003.

We have taken four restructuring charges: in the fourth quarter of 2001, the first quarter of 2002, the third quarter of 2002 and the fourth quarter of 2003. All of these charges were a part of plans approved by our Board of Directors, with the objective of eliminating duplicate resources and redundancies. A summary of each is outlined below.

In the fourth quarter of 2001, we recorded a charge of \$35.8 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, we undertook a review of our existing locations and elected to close a number of satellite offices and identified and notified approximately 700 employees whose positions with us were eliminated. The work force reductions affected approximately 150 members of management, 100 in research and development, 200 in sales and marketing and 250 in administrative functions. This charge consisted of the following: (i) employee termination benefits of \$6.4 million; (ii) facility closure charges of \$20.8 million, comprised of \$12.8 million in future lease obligations, exit costs and cancellation penalties, net of estimated sublease income of \$11.9 million, and \$8.0 million of non-cash fixed asset disposals related to vacating duplicate facilities and decreased equipment requirements due to lower headcount; (iii) non-cash write-offs of \$2.9 million in other assets related to exited activities; and (iv) accrued future payments of \$5.7 million for existing

---

contractual obligations with no future benefits to us.

In the first quarter of 2002, we revised our estimates related to a lease obligation and reduced the charge by \$488,000. During the second quarter of 2002, we revised our estimates related to our contractual obligations and reduced the charge by \$459,000. Our original estimate with respect to sublease income related primarily to a lease commitment for office space in San Francisco that expires in November 2006. We originally estimated that we would sublease the facility by the second quarter of 2003 at a rate of approximately two-thirds of the existing commitment. However, declines in the demand for office space in the San Francisco market led us to revise those estimates. Because we believed in 2002 it would take at least one year longer than was originally estimated to sublease the property and the market rates are projected to be as low as 33% of our current rent, we took an additional \$6.5 million charge in the third quarter of 2002. We also reduced our estimates for employee termination benefits by \$396,000 and our contractual obligations by \$339,000. Because we believed it would take at least one year longer than we originally estimated to sublease the last one-third of the San Francisco property, in the fourth quarter of 2003, we took an additional charge of \$1,290,000 for lease obligations and related charges. We also decreased our estimate related to our contractual obligations by \$203,000 and employee termination benefits by \$10,000. In the first quarter of 2004, we increased our estimate for lease obligations and related charges for our San Francisco property by \$139,000. As of September 30, 2004, one of the planned 700 employees previously notified of termination has not yet been paid severance.

In the first quarter of 2002, we recorded a charge of \$2.3 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, we undertook a review of our existing locations and elected to close offices and identified and notified approximately 270 employees whose positions with us were eliminated. The work force reductions affected approximately 30 members of management, 40 in research and development, 140 in sales and marketing and 60 in administrative functions. This charge consisted of employee termination benefits of \$1.7 million and facility closure charges of approximately \$600,000. In the third quarter of 2002, we evaluated our original estimates and concluded we must increase our charge for lease obligations by \$1.6 million because of a decline in market rates and reduced our estimate for employee termination pay by \$242,000. In the fourth quarter of 2003, we decreased our estimate for employee termination benefits by \$14,000 and increased our estimate for lease obligations and related charges by \$46,000. In the first quarter of 2004, the Company increased its charge for lease obligations by \$277,000 as a result of changes in exchange rates which increased our Canadian lease obligations. As of September 30, 2004, all of the planned 270 employees have been terminated and paid severance.

In the third quarter of 2002, we recorded a charge of \$3.6 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, we undertook a review of our existing locations and elected to close an office and identified and notified approximately 190 employees whose positions with us were eliminated. The work force reductions affected approximately 30 in research and development, 10 in production, 140 in sales and marketing and 10 in administrative functions. This charge consisted of employee termination benefits of \$1.6 million and facility closure charges of approximately \$2.0 million. In the fourth quarter of 2003, we decreased our estimates regarding employee termination benefits by \$133,000 and our lease obligations and related charges by \$417,000. As of September 30, 2004, all of the planned 190 employees have been terminated and paid severance.

In the fourth quarter of 2003, we recorded a charge of \$3.5 million, which was included in restructuring charges in the Consolidated Statement of Operations. As part of this restructuring and integration plan, we undertook a review of our existing operations and elected to change our management structure and identified and notified approximately 95 employees whose positions with the Company were eliminated. The work force reductions affected approximately seven in research and development, 17 in production, 37 in sales and marketing and 34 in administrative functions. This charge consists of employee termination benefits of \$1.4 million and stock-based charges related to the

acceleration of vesting of certain options for terminated management personnel of approximately \$2.1 million. In the first quarter of 2004, we reduced our estimate for employee termination benefits by \$71,000. As of September 30, 2004, all of the planned 95 employees previously notified of termination have been paid severance.

---

A summary of activity related to the four restructuring charges and the changes in our estimates is as follows (in thousands):

	<b>Employee Termination Benefits</b>	<b>Stock-based charges for Accelerated Vesting</b>	<b>Lease Obligations and Related Charges</b>	<b>Asset Write-offs</b>	<b>Contractual Obligations</b>	<b>Total</b>
December 2001 restructuring charge	\$ 6,364	\$	\$12,782	\$ 10,917	\$ 5,733	\$ 35,796
Cash paid	(3,511)		(137)		(141)	(3,789)
Non-cash charges				(10,917)		(10,917)
Restructuring accrual at December 31, 2001	2,853		12,645		5,592	21,090
March 2002 restructuring charge	1,720		309	260		2,289
Cash paid	(2,844)		(1,222)		(1,155)	(5,221)
Change in estimates			(488)			(488)
Non-cash charges			488	(260)		228
Restructuring accrual at March 31, 2002	1,729		11,732		4,437	17,898
Cash paid	(224)		(1,804)		(1,249)	(3,277)
Change in estimates					(459)	(459)
Sale of a subsidiary	(156)					(156)
Restructuring accrual at June 30, 2002	1,349		9,928		2,729	14,006
September 2002 restructuring charge	1,590		2,033			3,623
Cash paid	(693)		(1,492)		(707)	(2,892)
Change in estimates	(638)		8,099		(339)	7,122
Restructuring accrual at September 30, 2002	1,608		18,568		1,683	21,859
Cash paid	(1,155)		(1,402)		(520)	(3,077)
Restructuring accrual at December 31, 2002	453		17,166		1,163	18,782
Cash paid	(59)		(2,127)		(327)	(2,513)



Edgar Filing: HOMESTORE INC - Form 10-Q

Restructuring accrual at March 31, 2003	394		15,039		836	16,269
Cash paid	(216)		(1,671)		(180)	(2,067)
Restructuring accrual at June 30, 2003	178		13,368		656	14,202
Cash paid	(10)		(1,181)		(79)	(1,270)
Restructuring accrual at September 30, 2003	168		12,187		577	12,932
December 2003 restructuring charge	1,401	2,140				3,541
Cash paid	(511)		(1,496)		10	(1,997)
Change in estimates	(157)		919		(203)	559
Non-cash charges		(2,140)				(2,140)
Restructuring accrual at December 31, 2003	901		11,610		384	12,895
Cash paid	(737)		(1,425)		(4)	(2,166)
Change in estimates	(71)		416			345
Restructuring accrual at March 31, 2004	93		10,601		380	11,074
Cash paid	(54)		(1,058)		(4)	(1,116)
Restructuring accrual at June 30, 2004	39		\$ 9,543		376	9,958
Cash paid	(18)		(1,005)			(1,023)
Restructuring accrual at September 30, 2004	\$ 21	\$	\$ 8,538	\$	\$ 376	\$ 8,935

With the exception of payments associated with the San Francisco and other office lease commitments, substantially all of the remaining restructuring liabilities at September 30, 2004 will be paid during 2004. Any further changes to the accruals based upon current estimates will be reflected through the restructuring charges line in the Consolidated Statement of Operations.

**Stock-based charges.** The following chart summarizes the stock-based charges that have been included in the following captions for each of the periods presented (in thousands):

	<b>Three Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Revenue	\$	\$373
Cost of revenue		
Sales and marketing	75	446
Product and website development		
General and administrative	59	29
	<u>          </u>	<u>          </u>
	\$134	\$848
	<u>          </u>	<u>          </u>

Stock-based charges decreased by \$0.7 million to \$0.1 million for the three months ended September 30, 2004 from \$0.8 million for the three months ended September 30, 2003. The decrease is primarily due to the expiration of certain marketing agreements.

#### ***Interest Income (Expense), Net***

Interest income (expense), net, increased \$706,000 to a net interest income of \$472,000 for the three months ended September 30, 2004, from a net interest expense of \$234,000 for the three months ended September 30, 2003, primarily due to the receipt of approximately \$350,000 in interest on a security deposit held by the landlord of our corporate headquarters and increases in short-term investment balances and higher interest yields on those balances.

#### ***Other Income, Net***

Other income, net was \$2.2 million for the three months ended September 30, 2004, compared to other expense, net of \$195,000 for the three months ended September 30, 2003 primarily due to a \$1.4 million gain realized on the sale of an office building owned by the Company and an \$800,000 gain on the sale of assets.

#### ***Discontinued Operations***

On October 6, 2004, we entered into an Asset Purchase Agreement with Wyld Acquisition Corp. ( Wyld ), a wholly owned subsidiary of Siegel Enterprises, Inc., pursuant to which we agreed to sell our WyldFyre software business to Wyld for a purchase price of \$8.5 million in cash. The transaction closed on October 6, 2004. As a result, financial results of Homestore reflect the disposition of its WyldFyre business as discontinued operations. Previously reported results have been reclassified to reflect this presentation. Income from discontinued operations was approximately \$42,000 for the three months ended September 30, 2004 and approximately \$310,000 for the three months ended September 30, 2003.

#### ***Income Taxes***

As a result of operating losses and our inability to recognize a benefit from our deferred tax assets, we have not recorded a provision for income taxes for the three months ended September 30, 2004 and September 30, 2003. As of December 31, 2003, we had \$872.6 million of net operating loss carryforwards for federal income tax purposes, which expire beginning in 2008. We have provided a full valuation allowance on our deferred tax assets, consisting primarily of net operating loss carryforwards, due to the likelihood that we may not generate sufficient taxable income during the carryforward period to utilize the net operating loss carryforwards.

### ***Segment Information***

Segment information is presented in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon our internal organization and disclosure of revenue and operating expenses based upon internal accounting methods.

The expenses presented below for each of the business segments include an allocation of certain corporate expenses that are identifiable and benefit those segments and are allocated for internal management reporting purposes. The unallocated expenses are those corporate overhead expenses that are not directly attributable to a segment and include: corporate expenses, such as finance, legal, internal business systems, and human resources; amortization of intangible assets; litigation settlement charges; impairment charges; stock-based charges; and restructuring charges. There is no inter-segment revenue. Assets and liabilities are not fully allocated to segments for internal reporting purposes.

Summarized information by segment, as excerpted from internal management reports, is as follows (excluding discontinued operations (See Note 11)) (in thousands):

---

## Three Months Ended

	September 30, 2004					September 30, 2003				
	Media	Software	Print	Unallocated	Total	Media	Software	Print	Unallocated	Total
Revenue	\$37,151	\$5,838	\$13,092	\$	\$56,081	\$35,475	\$4,967	\$12,482	\$	\$ 52,924
Cost of revenue	6,010	1,849	5,053	205	13,117	7,630	2,194	4,852	330	15,006
Gross profit (loss)	31,141	3,989	8,039	(205)	42,964	27,845	2,773	7,630	(330)	37,918
Sales and marketing	15,024	1,260	5,123	166	21,573	17,987	1,398	5,061	1,176	25,622
Product and website development	2,565	1,578	61	25	4,229	2,707	1,674	90	2	4,473
General and administrative	5,157	838	2,488	14,012	22,495	4,802	680	2,451	8,754	16,687
Amortization of intangible assets				1,990	1,990				5,935	5,935
Impairment of long-lived assets									15,664	15,664
Total operating expenses	22,746	3,676	7,672	16,193	50,287	25,496	3,752	7,602	31,531	68,381
Income (loss) from operations	\$ 8,395	313	\$ 367	\$(16,398)	\$(7,323)	\$ 2,349	\$(979)	\$ 28	\$(31,861)	\$(30,463)

**Media Services**

Our Media Services segment consists of products and media services that promote and connect real estate professionals to consumers through our REALTOR.com®, HomeBuilder.com, RENTNET.com, and Homestore.com websites. In addition, we provide advertising services, including banner ads, sponsorships, integrated text based links and rich media applications to those businesses interested in reaching our targeted audience. This segment also includes our limited international activities.

Media Services revenue increased \$1.7 million, or 5%, to \$37.2 million for the three months ended September 30, 2004, compared to \$35.5 million for the three months ended September 30, 2003. An increase of \$2.9 million was generated in our Realtor business driven primarily by higher average spending per customer and our Retail business driven by higher effective cost-per-thousand impressions and higher sell-through rates. These increases were partially offset by a reduction in revenue from our HomeBuilder and RentNet businesses. Media Services revenue represented approximately 66% of total revenue for the three months ended September 30, 2004 compared to 67% of total revenue for the three months ended September 30, 2003.

Media Services expenses decreased by \$4.1 million, or 13%, to \$28.8 million for the three months ended September 30, 2004, from \$33.1 million for the three months ended September 30, 2003. The decrease was primarily due to cost of revenue savings of \$1.6 million due to a reduction in royalty expense, sales and marketing savings of \$2.7 million due to a reduction in online distribution costs related to new agreements, offset by other operating expense increases of \$0.2 million.

Media Services generated operating income of \$8.4 million for the three months ended September 30, 2004 compared to operating income of \$2.3 million for the three months ended September 30, 2003. We have announced plans for additional investments in our HomeBuilder and RentNet businesses that could negatively impact our operating income in this segment in the near future.

### *Software*

Our Software segment is comprised of our Top Producer and Computers for Tracts businesses. We recently sold our Wyldfyre business, which as a result has been reclassified as discontinued operations for all periods presented.

Software revenue increased \$0.9 million, or 18%, to \$5.8 million for the three months ended September 30, 2004, compared to \$4.9 million for the three months ended September 30, 2003. The increase is due to an increase in revenue from Top Producer as the subscriber base associated with the new online version of the Top Producer product has continued to grow since its launch in the second half of 2002 and has surpassed revenue being generated from the desktop version of the product. Software revenue represented approximately 10% of total revenue for the three months ended September 30, 2004 compared to 9% of total revenue for the three months ended September 30, 2003.

Software expenses decreased \$0.4 million, or 7%, to \$5.5 million for the three months ended September 30, 2004, compared to \$5.9 million for the three months ended September 30, 2003. The decrease was primarily due to reductions in personnel related costs due to our restructuring efforts.

---

Software generated operating income of \$0.3 million for the three months ended September 30, 2004, compared to an operating loss of \$1.0 million for the three months ended September 30, 2003 primarily due to factors outlined above.

### ***Print***

Our Print segment is comprised of our Welcome Wagon and Homestore Plans and Publications businesses.

Print revenue increased \$0.6 million, or 5%, to \$13.1 million for the three months ended September 30, 2004, compared to \$12.5 million for the three months ended September 30, 2003. The increase was generated in our Welcome Wagon business primarily due to an increase in the number of books distributed and an increase in the average revenue per book as advertising spending by local merchants increased. Print revenue represented approximately 23% of total revenue for the three months ended September 30, 2004 compared to 24% of total revenue for the three months ended September 30, 2003.

Print expenses have remained relatively constant, increasing only \$0.2 million, or 2%, to \$12.7 million for the three months ended September 30, 2004, compared to expenses of \$12.5 million for the three months ended September 30, 2003. Significant cost reductions were implemented during 2003 and although revenue has increased, operating costs have been controlled.

Print generated operating income of \$0.4 million for the three months ended September 30, 2004, compared to a breakeven for the three months ended September 30, 2003 primarily due to increased revenues outlined above. We have announced plans for additional investments in Welcome Wagon that could negatively impact our operating income in this segment in the near future.

### ***Unallocated***

Unallocated expenses decreased \$15.5 million, or 49%, to \$16.4 million for the three months ended September 30, 2004 from \$31.9 million for the three months ended September 30, 2003. The decrease was primarily due to a decrease in impairment of long-lived assets of \$15.7 million, amortization of intangibles of \$3.9 million, sales and marketing savings of \$1.0 million primarily due to a reduction in stock based charges, litigation settlement costs of \$1.0 million, and other cost savings of \$1.1 million primarily due to the implementation of our restructuring plans in 2003 and overall cost containment measures. These reductions were offset by our \$7.2 million accrual for the potential advancement of legal costs of former officers and directors. The reduction in amortization of intangibles is primarily due to the impairment charges taken in 2003 as well as certain intangible assets becoming fully amortized during 2003.

### ***Nine Months Ended September 30, 2004 and 2003***

#### ***Revenue and Related Party Revenue***

Revenue increased approximately \$8.3 million, or 5%, to \$166.4 million for the nine months ended September 30, 2004 from \$158.1 million for the nine months ended September 30, 2003. The primary reasons for the increase in revenue were increases in the Media Services segment of \$5.5 million, an increase of \$1.8 million in the Software segment and an increase of \$1.0 million in the Print segment. See the discussion of each segment's results below.

#### ***Cost of Revenue***

Cost of revenue decreased approximately \$4.9 million, or 11%, to \$39.8 million for the nine months ended September 30, 2004 from \$44.7 million for the nine months ended September 30, 2003. The decrease was primarily due to reductions in royalty expense of \$3.9 million and other cost reductions of \$1.0 million.

Gross margin percentage increased to 76% for the nine months ended September 30, 2004 compared to 72% for the nine months ended September 30, 2003. This improvement in gross margin percentage was primarily due to the factors noted above.

### ***Operating Expenses***

***Sales and marketing.*** Sales and marketing expenses, including non-cash stock-based charges, decreased approximately \$8.8 million, or 11%, to \$69.0 million for the nine months ended September 30, 2004 from \$77.8 million for the nine months ended September 30, 2003. The decrease was primarily due to reductions in stock based charges of \$3.5 million due to the expiration of previous marketing agreements, decreases in personnel related costs of \$3.5 million due to our restructuring efforts, a reduction of \$1.2 million in depreciation expense due to the sale of certain assets and assets being fully depreciated and other cost reductions of \$1.9 million. These decreases were offset by an increase in costs of \$1.3 million related to our new online marketing agreements.

***Product and website development.*** Product and website development expenses decreased approximately \$1.7 million, or 12%, to \$12.6 million for the nine months ended September 30, 2004 from \$14.3 million for the nine months ended September 30, 2003 primarily due to a decrease in personnel related costs due to our restructuring efforts.

***General and administrative.*** General and administrative expenses, including non-cash stock-based charges, decreased approximately \$0.1 million to \$51.8 million for the nine months ended September 30, 2004 from \$51.9 million for the nine months ended September 30, 2003. The decrease was primarily due to decreases in personnel related costs of \$6.5 million due to our restructuring efforts, decreases in bad debt expense of \$2.2 million due to improved collections and other cost reductions of \$1.0 million. These decreases were offset by our accrual of \$7.2 million for the potential advancement of legal costs of former officers and directors and increases in legal and accounting fees and consulting expenses of \$2.4 million primarily due to shareholder litigation costs and the cost of compliance with Section 404 of the Sarbanes-Oxley Act of 2002.

---

**Amortization of intangible assets.** Amortization of intangible assets was \$6.4 million for the nine months ended September 30, 2004 compared to \$19.9 million for the nine months ended September 30, 2003. The decrease in amortization was primarily due to the impairment of intangible assets charged under SFAS No. 142 and SFAS No. 144, recorded during 2003 as well as certain intangible assets becoming fully amortized during 2004.

**Litigation Settlement.** As a result of our settlement of the Top Producer and Siegel litigation, as discussed in Note 12, Settlement of Disputes and Litigation, we recorded a litigation settlement charge of \$2.2 million in our operating results for the nine months ended September 30, 2004 compared to \$63.6 million related to the settlement of the Securities Class Action Lawsuit for the nine months ended September 30, 2004.

**Impairment of long-lived assets.** In conjunction with business units continuing to perform below our expectations, as required by SFAS Nos. 144 and 142, we performed an impairment analysis as of September 30, 2003. Our analysis resulted in a charge of \$15.7 million in the nine months ended September 30, 2003 comprised of impairments of \$11.8 million of identifiable intangible assets relating to our apartments and rentals business, \$2.6 million of intangibles, goodwill and property and equipment relating to the acquisition of Computers for Tracts and \$1.3 million of prepaid distribution expense.

In conjunction with the settlement of the dispute with Cendant we relinquished certain exclusive data rights and other rights. As a result, certain intangible assets associated with those rights no longer had value to the Company, and accordingly, we recorded an impairment charge of \$12.2 million in our operating results for the nine months ended September 30, 2003.

**Restructuring charges.** Restructuring charges were \$345,000 for the nine months ended September 30, 2004 as a result of changes in exchange rates increasing our Canadian lease obligation. There were no changes in estimates recorded for previous restructuring plans during the nine months ended September 30, 2003, and there were no new restructuring plans approved during this period.

**Stock-based charges.** The following chart summarizes the stock-based charges that have been included in the following captions for each of the periods presented (in thousands):

	<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Revenue	\$	\$1,119
Cost of revenue		16
Sales and marketing	226	3,719
Product and website development		15
General and administrative	459	135
	<u>        </u>	<u>        </u>
	\$685	\$5,004
	<u>        </u>	<u>        </u>

Stock-based charges decreased by \$4.3 million to \$0.7 million for the nine months ended September 30, 2004 from



\$5.0 million for the nine months ended September 30, 2003. The decrease is primarily due to the expiration of certain marketing agreements.

***Interest Income (Expense), Net***

Interest income (expense), net, increased \$702,000 to an income of \$414,000 for the nine months ended September 30, 2004, from net expense of \$288,000 for the nine months ended September 30, 2003, primarily due to the receipt of approximately \$350,000 in interest on a security deposit held by the landlord of our corporate headquarters and increases in short-term investment balances and higher interest yields on those balances.

***Gain on Settlement of Distribution Agreement***

In January 2003, we entered into a new marketing agreement with AOL that resolved our dispute with AOL and terminated the obligation under the old agreement. In connection with the settlement, we reduced our accrued distribution obligation and other accrued liabilities by \$189.9 million and \$4.2 million, respectively, and allowed AOL to fully draw down on an existing \$90.0 million letter of credit secured by restricted cash on our consolidated balance sheet at December 31, 2002. Accordingly, we recorded a gain on settlement of the distribution agreement of \$104.1 million for the nine months ended September 30, 2003. The January 2003 marketing agreement expired on June 30, 2004, and was replaced with an agreement that extends through December 31, 2005.

***Other Income, Net***

Other income, net was \$2.2 million for the nine months ended September 30, 2004 compared to \$749,000 for the nine months ended September 30, 2003 due primarily to a \$1.4 million gain realized on the sale of an office building owned by the Company and an \$800,000 gain on the sale of other assets. Other income, net of \$749,000 for the nine months ended September 30, 2003 consists primarily of a gain from the release of proceeds during the first quarter of 2003 from an escrow on the sale of assets in previous quarters.

---

**Discontinued Operations**

On October 6, 2004, we entered into an Asset Purchase Agreement with Wyld Acquisition Corp. ( Wyld ), a wholly owned subsidiary of Siegel Enterprises, Inc., pursuant to which we agreed to sell our WyldFyre software business to Wyld for a purchase price of \$8.5 million in cash. The transaction closed on October 6, 2004. As a result, the financial results of Homestore reflect the disposition of its WyldFyre business as discontinued operations. Previously reported results have been reclassified to reflect this presentation. The loss from discontinued operations was approximately \$807,000, for the nine months ended September 30, 2004 compared to a loss from discontinued operations of approximately \$167,000 for the nine months ended September 30, 2003.

On April 2, 2002, we sold our Consumer Info division for \$130.0 million in cash to Experian Holdings, Inc. In accordance with SFAS No. 144, the unaudited Condensed Consolidated Financial Statements reflect this as discontinued operations. We recorded a gain on disposition of discontinued operations of \$2.5 million during the nine months ended September 30, 2003, as a result of the receipt of cash and stock valued at \$230,000 released from our escrow related to our purchase of iPlace, Inc. and the receipt of \$2.3 million in cash from our escrow related to the sale of our ConsumerInfo division.

**Income Taxes**

As a result of operating losses and our inability to recognize a benefit from our deferred tax assets, we have not recorded a provision for income taxes for the nine months ended September 30, 2004 and September 30, 2003. As of December 31, 2003, we had \$872.6 million of net operating loss carryforwards for federal income tax purposes, which expire beginning in 2008. We have provided a full valuation allowance on our deferred tax assets, consisting primarily of net operating loss carryforwards, due to the likelihood that we may not generate sufficient taxable income during the carryforward period to utilize the net operating loss carryforwards.

**Segment Information**

Summarized information by segment, as excerpted from internal management reports, is as follows (excluding discontinued operations (See Note 11)) (in thousands):

	<b>Nine Months Ended</b>									
	<b>September 30, 2004</b>					<b>September 30, 2003</b>				
	<b>Media</b>	<b>Software</b>	<b>Print</b>	<b>Unallocated</b>	<b>Total</b>	<b>Media</b>	<b>Software</b>	<b>Print</b>	<b>Unallocated</b>	<b>Total</b>
Revenue	\$ 112,490	\$ 17,117	\$ 36,804	\$	\$ 166,411	\$ 107,002	\$ 15,308	\$ 35,837	\$	\$ 158,147
Cost of revenue	18,941	5,410	14,785	629	39,765	23,051	5,858	14,656	1,122	44,687
Gross profit (loss)	93,549	11,707	22,019	(629)	126,646	83,951	9,450	21,181	(1,122)	113,460
Sales and marketing	49,827	4,073	14,577	521	68,998	51,973	5,808	14,264	5,782	77,827
Product and website	7,824	4,629	181	2	12,636	8,719	5,223	359	19	14,320

Edgar Filing: HOMESTORE INC - Form 10-Q

development										
General and administrative	14,447	2,385	7,439	27,562	51,833	18,287	2,545	7,790	23,357	51,979
Amortization of intangible assets				6,432	6,432				19,874	19,874
Litigation settlement				2,168	2,168				63,600	63,600
Impairment of long-lived assets									27,822	27,822
Restructuring charges				345	345					
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total operating expenses	<u>72,098</u>	<u>11,087</u>	<u>22,197</u>	<u>37,030</u>	<u>142,412</u>	<u>78,979</u>	<u>13,576</u>	<u>22,413</u>	<u>140,454</u>	<u>255,422</u>
Income (loss) from operations	<u>\$ 21,451</u>	<u>\$ 620</u>	<u>\$ (178)</u>	<u>\$(37,659)</u>	<u>\$(15,766)</u>	<u>\$ 4,972</u>	<u>\$(4,126)</u>	<u>\$(1,232)</u>	<u>\$(141,576)</u>	<u>\$(141,962)</u>

**Media Services**

Our Media Services segment consists of products and media services that promote and connect real estate professionals to consumers through our REALTOR.com®, HomeBuilder.com, RENTNET.com, and Homestore.com websites. In addition, we provide

advertising services, including banner ads, sponsorships, integrated text based links and rich media applications to those businesses interested in reaching our targeted audience. This segment also includes our limited international activities.

Media Services revenue increased approximately \$5.5 million, or 5%, to \$112.5 million for the nine months ended September 30, 2004, compared to \$107.0 million for the nine months ended September 30, 2003. An increase of \$8.9 million was generated in our Realtor business driven primarily by higher average spending per customer and our Retail business driven by higher effective cost-per-thousand impressions and higher sell-through rates. These increases were partially offset by a reduction in revenue from our HomeBuilder and RentNet businesses. Media Services revenue represented approximately 68% of total revenue for each of the nine-month periods ended September 30, 2004 and September 30, 2003.

Media Services expenses decreased by \$11.0 million, or 11%, to \$91.0 million for the nine months ended September 30, 2004, from \$102.0 million for the nine months ended September 30, 2003. The decrease was primarily due to decreases in personnel related costs of \$3.9 million due to our restructuring efforts, cost of revenue savings of \$3.4 million due to a reduction in royalty expense, general and administrative savings of \$3.1 million due to improved collections resulting in lower bad debt expense, and other operating expense reductions of \$0.6 million.

Media Services generated an operating income of \$21.5 million for the nine months ended September 30, 2004 compared to operating income of \$5.0 million for the nine months ended September 30, 2003. We have announced plans for additional investments in our HomeBuilder and RentNet businesses that could negatively impact our operating income in this segment in the near future.

### *Software*

Our Software segment is comprised of our Top Producer and Computers for Tracts businesses. We recently sold our Wyldfyre business, which as a result has been reclassified as discontinued operations for all periods presented.

Software revenue increased \$1.8 million, or 12%, to \$17.1 million for the nine months ended September 30, 2004, compared to \$15.3 million for the nine months ended September 30, 2003. The increase was generated by the Top Producer business as the subscriber base associated with the new online version of the Top Producer product has continued to grow since its launch in the second half of 2002 and has surpassed revenue being generated from the desktop version of the product. Software revenue represented approximately 10% of total revenue for each of the nine-month periods ended September 30, 2004 and September 30, 2003.

Software expenses decreased \$2.9 million, or 15%, to \$16.5 million for the nine months ended September 30, 2004, compared to \$19.4 million for the nine months ended September 30, 2003. The decrease was primarily due to reductions in personnel related costs due to our restructuring efforts.

Software generated operating income of \$0.6 million for the nine months ended September 30, 2004, compared to an operating loss of \$4.1 million for the nine months ended September 30, 2003 primarily due to factors outlined above.

### *Print*

Our Print segment is comprised of our Welcome Wagon and Homestore Plans and Publications businesses.

Print revenue increased \$1.0 million, or 3%, to \$36.8 million for the nine months ended September 30, 2004, compared to \$35.8 million for the nine months ended September 30, 2003. The increase is primarily due to an increase

in revenue from Welcome Wagon associated with the new Pinpoint product launched in early 2003. Print revenue represented approximately 22% of total revenue for each of the nine-month periods ended September 30, 2004 and September 30, 2003.

Print expenses remained flat at \$37.0 million for the nine months ended September 30, 2004 and the nine months ended September 30, 2003.

Print generated an operating loss of \$0.2 million for the nine months ended September 30, 2004, compared to an operating loss of \$1.2 million for the nine months ended September 30, 2003 primarily due to the revenue increases outlined above. We have announced plans for additional investments in Welcome Wagon that could negatively impact our operating income in this segment in the near future.

### ***Unallocated***

Unallocated expenses decreased \$103.9 million, or 73%, to \$37.7 million for the nine months ended September 30, 2004 from \$141.6 million for the nine months ended September 30, 2003. The decrease was primarily due to a decrease in litigation settlement charges of \$61.4 million, impairment of long-lived assets of \$27.8 million, amortization of intangibles of \$13.4 million, sales and marketing savings of \$5.3 million primarily due to reduced stock based charges, and other costs of \$3.2 million primarily related to a reduction in operating expenses due to the implementation of our restructuring plans in 2003. These reductions were offset by our \$7.2 million accrual for the potential advancement of legal costs of former officers and directors. The reduction in amortization of intangibles is primarily due to the impairment charges taken in 2003 as well as certain intangible assets becoming fully amortized during 2004.

### ***Liquidity and Capital Resources***

Net cash provided by continuing operating activities of \$7.8 million for the nine months ended September 30, 2004 was attributable to the net loss from continuing operations of \$13.1 million, offset by non-cash expenses including depreciation, amortization of intangible assets, provision for doubtful accounts, stock-based charges and other non-cash items, aggregating to \$13.9 million.

---

Increasing the cash provided by operations were variances in operating assets and liabilities of \$7.0. Due to the impact of our restructuring efforts in 2003 and 2002, and the impairment and litigation settlement charges, the cash flow from operations for the nine months ended September 30, 2003 is not comparable to our current results. Net cash used in continuing operating activities was \$26.4 million for the nine months ended September 30, 2003.

Net cash used in investing activities of \$10.5 million for the nine months ended September 30, 2004 was primarily attributable to capital expenditures due to the implementation of our new enterprise reporting system and purchases of other technology servers of \$3.9 million and net purchases of short-term investments of \$12.6 million offset by proceeds of \$6.0 million from the sale of certain real property owned by the Company. Net cash used in investing activities of \$26.3 million for the nine months ended September 30, 2003 was attributable to capital expenditures primarily due to the implementation of our new enterprise reporting system of \$6.6 million and the purchase of short-term investments of \$21.0 million partially offset by the sale of assets of \$1.3 million.

Net cash provided by financing activities of \$3.3 million for the nine months ended September 30, 2004 was attributable to the exercise of stock options, warrants and share issuances under the employee stock purchase plan. Net cash provided by financing activities of \$2.3 million for the nine months ended September 30, 2003 was also the result of the exercise of stock options, warrants and share issuances under employee stock purchase plan of \$2.2 million.

Since inception, we have incurred losses from operations and have reported negative operating cash flows. As of September 30, 2004, we had an accumulated deficit of \$2.0 billion and cash and short-term investments of \$48.0 million. We have also stated our intention to invest in our products and our infrastructure although we have not determined the actual amount of those future expenditures. We have no material financial commitments other than those under capital and operating lease agreements and distribution and marketing agreements described in Item 7,

Management's Discussion and Analysis of Financial Condition and Results of Operations, included in our Form 10-K for the year ended December 31, 2003. Our contractual obligations have not changed materially from December 31, 2003. We believe that our existing cash and short-term investments, and any cash generated from operations will be sufficient to fund our working capital requirements, capital expenditures and other obligations through the next 12 months.

Long term, we face significant risks associated with the successful execution of our business strategy and may need to raise additional capital in order to fund more rapid expansion, to expand our marketing activities, to develop new, or enhance existing, services or products and to respond to competitive pressures or to acquire complementary services, businesses or technologies. If we are not successful in continuing to generate sufficient cash flow from operations, we may need to raise additional capital through public or private financing, strategic relationships or other arrangements. Our settlement of the Securities Class Action Lawsuit reduced our cash balance by \$13.0 million and increased the number of outstanding shares by 20.0 million, which may make it more difficult to raise additional capital. This additional capital, if needed, might not be available on terms acceptable to us, or at all. If adequate funds are not available or not available on acceptable terms, we may be unable to develop or enhance our products and services, take advantage of future opportunities, or respond to competitive pressures or unanticipated requirements which may have a material adverse effect on our business, financial condition or operating results. If additional capital were raised through the issuance of equity securities, the percentage of our stock owned by our then-current stockholders would be further reduced. Furthermore, these equity securities might have rights, preferences or privileges senior to those of our common and convertible preferred stock. In addition, our liquidity could be adversely impacted by the litigation referred to in Note 12, Settlement of Disputes and Litigation and Note 13, Commitments and Contingencies to our Condensed Consolidated Financial Statements.

### ***Recent Accounting Developments***

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51, or FIN 46. FIN 46 provides guidance for determining whether and how to consolidate variable interest entities, or VIEs. Variable interests are contractual, ownership or other interests in an entity that expose their holders to the risks and rewards of the VIE. Variable interests include equity investments, loans, leases, derivatives, guarantees and other instruments whose values change with changes in the VIEs assets. Any of these instruments may require its holder to consolidate the VIE. FIN 46 requires certain VIEs to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. For entities created before January 31, 2003, the provisions of FIN 46 were delayed until March 31, 2004. The adoption of FIN 46 in the first quarter of 2004 did not have a material impact on our financial position, results of operations, or financial statement disclosures.

---

## RISK FACTORS

*You should consider carefully the following risk factors, and those presented in our Annual Report on Form 10-K for the year ended December 31, 2003, and other information included or incorporated by reference in this Quarterly Report on Form 10-Q. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we deem to be currently immaterial also may impair our business operations. If any of the following risks actually occur, our business, financial condition and operating results could be materially adversely affected.*

### ***We have a history of net losses and expect net losses for the foreseeable future.***

Except for the first quarter of 2003, for which we experienced a net profit due to a one-time non-cash gain on the settlement of a distribution agreement, we have experienced net losses in each quarterly and annual period since 1993. We incurred net losses of \$47.1 million, \$163.4 million, and \$1.5 billion for the years ended December 31, 2003, 2002 and 2001, respectively. As of September 30, 2004, we had an accumulated deficit of \$2.0 billion, and are unsure when or if we will become profitable on a recurring basis. The size of our future losses will depend, in part, on the rate of growth in our subscription revenues from broker, agent, HomeBuilder and rental property owner, advertising sales and sales of other products and services. The size of our future net losses will also be impacted by non-cash stock-based charges relating to deferred compensation and stock and warrant issuances, and amortization of intangible assets. As of September 30, 2004, we had approximately \$21.3 million of stock-based charges and intangible assets to be amortized. In addition, we will continue to use cash to repay existing liabilities that have arisen from prior contractual arrangements and recent restructuring charges until those liabilities are satisfied.

### ***Our quarterly financial results are subject to significant fluctuations.***

Our results of operations may vary significantly from quarter to quarter. In the near term, we expect to be substantially dependent on sales of our subscription and advertising products and media services. We also expect to incur significant sales and marketing expenses to promote our brand and services. Therefore, our quarterly revenue and operating results are likely to be particularly affected by the number of customers purchasing subscription and advertising products and media services as well as our expenditures on sales and marketing for a particular period. If revenue falls below our expectations, we will not be able to reduce our spending rapidly in response to the shortfall.

Other factors that could affect our quarterly operating results include those described below and elsewhere in this Form 10-Q:

the level of renewals for our subscription products and the purchase of media services by real estate agents, brokers and rental property owners and managers;

the amount of advertising sold on our websites and the timing of payments for this advertising;

the amount and timing of our operating expenses;

the amount and timing of non-cash stock-based charges, such as charges related to deferred compensation or warrants issued to real estate industry participants;

the sale or disposition of assets; and

the impact of fees paid to professional advisors in connection with litigation and accounting matters.

***Litigation relating to accounting irregularities could have an adverse effect on our financial condition.***



Following the December 2001 announcement of the discovery of accounting irregularities, approximately 20 lawsuits claiming to be class actions and six lawsuits claiming to be brought derivatively on our behalf were commenced in various courts against us and certain of our former officers, directors and employees by or on behalf of persons purporting to be our stockholders and persons claiming to have purchased or otherwise acquired securities issued by us between May 2000 and December 2001. The California State Teachers Retirement System has been named lead plaintiff, or the Plaintiff, in the consolidated shareholder lawsuits against us. In November 2002, the Plaintiff filed a first amended consolidated class action complaint, or Securities Class Action Lawsuit, naming us, certain of our current officers, directors and employees, certain of our former officers, directors and employees and various other parties, including among others PricewaterhouseCoopers LLP, as defendants. The amended complaint makes various allegations, including that we violated federal securities laws, and seeks an unspecified amount of damages.

On March 7, 2003, the court dismissed, with prejudice, the Plaintiff's claims against a number of corporate and individual defendants whom the Plaintiff alleged either assisted in the planning and execution of the purportedly fraudulent transactions at issue, or who were parties to those transactions. The court also dismissed, without prejudice, the Plaintiff's claims against a number of our current and former officers and employees. With regard to those claims dismissed without prejudice, the Plaintiff has advised that it does not intend to amend the complaint. At the same time, the court denied the motions to dismiss PricewaterhouseCoopers LLP and our former chief executive officer. We did not file a motion to dismiss the Plaintiff's claims against us, but answered the complaint. Accordingly, the March 7, 2003 decision did not make any ruling with respect to the claims asserted against us.

---

On August 12, 2003, we entered into a settlement agreement with the Plaintiff to resolve all outstanding claims related to the Securities Class Action Lawsuit. On October 8, 2003, the District Court preliminarily approved the settlement. A final hearing on the settlement was held on January 16, 2004, after delivery of notice to class members. On February 5, 2004, the Court issued an interim order generally approving the terms of the settlement as fair, adequate and reasonable, but directing additional briefing on two issues: (1) whether certain objectors' proposal to carve out certain claims from the settlement is feasible; and (2) whether notice to class members was potentially inadequate because of the short time period given to file their claims. The Court suggested that the parties consider allowing additional time for class members to file claims, which would not affect the total settlement fund. On March 16, 2004, the Court issued its Order Granting Motion for Final Approval of Partial Class Settlement and Directing Renotice of the Class. The Order directed that an abbreviated class notice be published and extended the deadline for class members to opt out or submit claims until May 31, 2004. On May 14, 2004, the District Court entered final judgment and an order of dismissal with prejudice as to the Company. The final judgment includes a bar order providing for the maximum protection to which the Company is entitled under the law with respect to all future claims for contribution or indemnity by other persons, whether under federal, state or common law. On June 10, 2004, an objector to the settlement filed a notice of appeal. In his appeal, the objector has raised deficiencies in the notice program for providing notice to class members of the class settlement.

As a part of the settlement, we agreed to pay \$13.0 million in cash and issue 20.0 million new shares of our common stock valued at \$50.6 million as of August 12, 2003. In October 2003, we placed \$10.0 million in escrow upon preliminary approval by the U.S. District Court, with the additional \$3.0 million paid in April 2004. Following final judicial approval of the settlement, the \$13.0 million and 20.0 million shares of newly issued common stock will be distributed to the class. The issuance of the shares will be exempt from registration under Section 3(a)(10) of the Securities Act of 1933. As a result of the settlement, we recorded a litigation settlement charge of \$63.6 million in our operating results for the year ended December 31, 2003. In addition, we have agreed to adopt, within thirty days of final approval of the settlement, certain corporate governance principles that have been approved by the Board of Directors, including requirements for independent directors and special committees, a non-classified Board of Directors with two-year terms, appointment of a new shareholder-nominated director, prohibition on the future use of stock options for director compensation and minimum stock retention by officers after exercise of future stock option grants. We will also divide equally with the class any future net proceeds from insurance with respect to the litigation after provision for legal expenses incurred by us. The Plaintiff has agreed that any members of the class who participate in the settlement will release and discharge all claims against us. We are aware that several persons who purportedly acquired our shares during the class period of January 1, 2000 through December 21, 2002, representing less than 1% of our outstanding shares, have notified the Plaintiff that they wish to be excluded from the settlement.

There are still additional risks to the Company related to the Securities Class Action Lawsuit. These risks include the pending appeal of the United States District Court's order approving the settlement, suits by persons who elect to be excluded from the settlement or whose claims against the Company may not be discharged or barred by the settlement.

In addition, we are subject to several other shareholder and derivative lawsuits relating to accounting irregularities that could have an adverse effect on our business. See Note 13 Commitments and Contingencies contained in Part I to this Form 10-Q for more information.

***Limitations of our Director and Officer Liability Insurance and potential indemnification obligations may adversely affect our financial condition.***

Several securities and derivative actions currently are pending against us and certain of our former and current officers and directors. During the relevant time period, our liability insurance provided limited claims-made coverage for allegations of wrongful acts by our officers and directors, which allegations, in part, form the basis of the pending

actions. During the relevant time period, our insurers provided a total of \$80.0 million in primary and excess coverage. As the policies are written and subject to their unique terms and provisions our officers and directors are insureds under the applicable policies. We, as an entity, also are an insured party under those applicable policies, which represents the first \$30.0 million in coverage. The failure of our policies to adequately cover liabilities or expenses incurred in connection with the pending actions could materially and adversely affect our financial condition.

Several of our insurance carriers representing \$60.0 million in coverage also have purported to rescind their respective policies of insurance and have filed lawsuits seeking judicial confirmation of their actions. The failure of our policies to cover liabilities imposed or expenses incurred in connection with the pending actions could materially and adversely affect our financial condition.

Under Delaware and California law, our certificate of incorporation and bylaws, and certain indemnification agreements we entered into with our executive officers and directors, we may have certain obligations to indemnify our current and former officers and directors. The indemnification may cover any expenses and/or liabilities reasonably incurred in connection with the investigation, defense, settlement or appeal of legal proceedings. One of our former officers filed a lawsuit against us seeking to recover expenses incurred, plus further expenses and liabilities that he may incur, in connection with the SEC and Department of Justice investigations and lawsuits that have been filed against him with respect to our prior accounting irregularities. See Note 13 of Item 1, Commitments and Contingencies. On October 27, 2004, the Court ruled that we are obligated to advance all reasonable attorney's fees and costs to that former officer. Other former officers and directors likely have incurred and will incur similar expenses and liabilities and those who have not pled guilty to crimes may also seek recovery of those amounts from us. Although we may appeal the decision, we have established a \$7.2 million accrual for our estimate of those expenses through September 2004. We may have to spend this amount and more indemnifying these officers and directors or paying for damages that they may incur. Our financial condition could be materially and adversely affected if we have to make these payments for indemnification.

---

*We continue to incur costs related to the SEC investigation of prior accounting irregularities.*

In December 2001, we announced that the Audit Committee of our Board of Directors was conducting an inquiry into certain of our accounting practices and that the results of the inquiry to date indicated that our unaudited interim financial statements for 2001 would require restatement. In February 2002, we announced that we would restate our financial results for the year ended December 31, 2000. In connection with the restatement, in March 2002 we filed an amended Form 10-K for the year ended December 31, 2000 and amended Form 10-Qs for the first three quarters of 2001.

In January 2002, we were notified that the SEC had issued a formal order of private investigation in connection with the accounting matters that resulted in the restatement of our financial statements. The SEC requested that we provide them with certain documents concerning the restatement. The SEC also requested access to certain of our current and former employees for interviews. We have cooperated and continue to cooperate fully with the SEC's investigation.

Since September 2002, certain of our former employees have entered into plea agreements with the United States Attorney's Office and the SEC in connection with the investigation. Also in September 2002, the SEC and the Department of Justice informed us that, in light of the actions taken by our Board of Directors and our Audit Committee and our cooperation in the SEC's investigation, those agencies would not bring any enforcement action against us. Because the SEC and DOJ investigations are ongoing and we are committed to cooperating with those investigations, we will likely continue to incur additional costs related to the investigation and management time and attention may be diverted until the investigation concludes.

---

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

#### **Interest Rate Risk**

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. We invest our excess cash in debt instruments of the U.S. Government and its agencies, and in high-quality corporate issuers and, by policy, this limits the amount of credit exposure to any one issuer.

Investments in both fixed rate and floating rate interest earning instruments carries a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall.

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

The Company carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report, as required by Rule 13a-15 under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were designed and were functioning effectively to provide reasonable assurance that material information about us and our subsidiaries, required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules.

A controls system, no matter how well designed and operated, cannot provide absolute assurance that its objectives are met, and no evaluation of controls can provide absolute assurance that all control issues and any instances of fraud, within a company will be detected. It should also be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In connection with the evaluation required by Exchange Act Rule 13a-15(d), our management, including the Chief Executive Officer and Chief Financial Officer, concluded that no significant changes in our internal control over financial reporting occurred during the third quarter of 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

In connection with the audit for the fiscal year ended December 31, 2003, our management and our independent auditors, Ernst & Young LLP, reported to our Audit Committee two matters involving internal controls that our independent auditors considered to be reportable conditions, but that were not material weaknesses, under standards established by the American Institute of Certified Public Accountants. The identified deficiencies were that we should 1) perform more timely reconciliations and reviews of our detailed financial records to the general ledgers and 2) improve and maintain documentation of all accounting policies and procedures as well as all of management's key assumptions, estimates and conclusions that affect our recorded balances in our financial statements.

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

To respond specifically to these matters, to assure that these matters do not adversely affect our disclosure controls and to meet our obligations under Section 404 of the Sarbanes-Oxley Act of 2002, we have commenced an overall review of our internal controls over financial reporting. As part of the assessment of our internal controls, with the

assistance of outside consultants, we continue to review, evaluate and remediate our internal processes in order to strengthen and establish greater uniformity in their application. As a result of these steps, we intend to continue to refine our internal control processes on an ongoing basis. With respect to the financial close process, we have reviewed key procedures and have realigned those procedures to improve the efficiency and accuracy of the process as well as provide enhanced evidence of timely reconciliations and reviews.

During the second quarter of 2004, we implemented certain modules of PeopleSoft financials in conjunction with the first phase of a company-wide enterprise resource planning initiative. In connection therewith, we have updated our internal controls over financial reporting as necessary to accommodate any modifications to our internal processes and accounting procedures, including the improvement and retention of documentation of all accounting policies and procedures as well as all of management's key assumptions, estimates and conclusions that affect its recorded balances in its financial statements.

While we are in the process of taking the foregoing steps, the effectiveness of the changes we have made to date and the improvements we are in the process of implementing are subject to continued management review supported by confirmation and testing by management and by our external consultants and independent auditors.

---

## **PART II. OTHER INFORMATION**

### **Item 1. *Legal Proceedings***

From time to time, we are party to various litigation and administrative proceedings relating to claims arising from our operations in the ordinary course of business. See the disclosure regarding litigation included in Note 12, Settlement of Disputes and Litigation, and Note 13, Commitments and Contingencies, to our unaudited Condensed Consolidated Financial Statements contained in Part I to this Form 10-Q, which disclosure is incorporated herein by reference and updates information contained in the Form 10-Qs for the quarters ended March 31, 2004 and June 30, 2004. As of the date of this Form 10-Q and except as set forth herein, we are not a party to any other litigation or administrative proceedings that management believes will have a material adverse effect on our business, results of operations, financial condition or cash flows.

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

The settlement of the lawsuits brought by former shareholders of Top Producer described in Note 12, Settlement of Disputes and Litigation Settlement of Other Securities Litigation, to our unaudited Condensed Consolidated Financial Statements contained in Part I of this Form 10-Q included the issuance of 2,325,036 shares of our common stock to former shareholders and employees of Top Producer in exchange for their claims against Homestore. The settlement was approved by the Superior Court of California, County of Los Angeles, in June 2004, and the shares were issued on July 6, 2004. The shares of common stock were issued without registration in reliance upon the exemption provided by Section 3(a)(10) of the Securities Act.

The settlement of the lawsuit brought by certain former owners and directors of iPlace described in Note 12, Settlement of Disputes and Litigation Settlement of Other Securities Litigation, to our unaudited Condensed Consolidated Financial Statements contained in Part I of this Form 10-Q included the issuance of an aggregate of 177,631 shares of our common stock to the plaintiffs in exchange for their claims against Homestore. The settlement was approved by the United States District Court for the Central District of California, Western Division, in July 2004, and the shares were issued on July 9, 2004. The shares of common stock were issued without registration in reliance upon the exemption provided by Section 3(a)(10) of the Securities Act.

### **Item 3. *Defaults Upon Senior Securities***

None.

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

None.

### **Item 5. *Other Information***

None.

### **Item 6. *Exhibits***

*Exhibits*

- 10.1 Asset Purchase Agreement dated October 6, 2004 between Homestore, Inc. and Wyld Acquisition Corp.
  - 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
-



**SIGNATURES**

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

HOMESTORE, INC.

By:                   /s/ W. MICHAEL LONG                  

W. Michael Long  
*Chief Executive Officer*

By:                   /s/ LEWIS R. BELOTE, III                  

Lewis R. Belote, III  
*Chief Financial Officer*

Date: November 5, 2004

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
10.1	Asset Purchase Agreement dated October 6, 2004 between Homestore, Inc. and Wyld Acquisition Corp.
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.