COMMERCE BANCSHARES INC /MO/
Form 10-Q
August 07, 2007

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to
Commission File No. 0-2989

COMMERCE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Missouri (State of Incorporation)	**43-0889454** (IRS Employer Identification No.)
1000 Walnut, **Kansas City, MO** (Address of principal executive offices)	**64106** (Zip Code)

(816) 234-2000
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No __

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

Large accelerated filer X Accelerated filer__ Non-accelerated filer__

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes_ No X

As of August 1, 2007, the registrant had outstanding 68,654,787 shares of its $5 par value common stock, registrant s only class of common stock.

Commerce Bancshares, Inc. and Subsidiaries

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PART I: FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS

	June 30 2007	December 31 2006
	(Unaudited)	
	(In thousands)	
ASSETS		
Loans, net of unearned income	**$ 10,225,921**	$ 9,681,520
Allowance for loan losses	**(132,960)**	(131,730)
Net loans	**10,092,961**	9,549,790
Loans held for sale	**258,563**	278,598
Investment securities:		
Available for sale ($526,509,000 pledged in 2007 and $526,430,000 pledged in 2006 to secure structured repurchase agreements)	**3,129,310**	3,415,440
Trading	**19,600**	6,676
Non-marketable	**92,213**	74,207
Total investment securities	**3,241,123**	3,496,323
Federal funds sold and securities purchased under agreements to resell	**566,145**	527,816
Cash and due from banks	**497,909**	626,500
Land, buildings and equipment, net	**397,108**	386,095
Goodwill	**110,705**	97,643
Other intangible assets, net	**18,052**	19,633
Other assets	**336,805**	247,951
Total assets	**$ 15,519,371**	$ 15,230,349

LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits:		
Non-interest bearing demand	**$ 1,271,730**	$ 1,312,400
Savings, interest checking and money market	**6,910,086**	6,879,047
Time open and C.D. s of less than $100,000	**2,363,580**	2,302,567
Time open and C.D. s of $100,000 and over	**1,516,326**	1,250,840
Total deposits	**12,061,722**	11,744,854
Federal funds purchased and securities sold under agreements to repurchase	**1,494,604**	1,771,282
Other borrowings	**346,137**	53,934
Other liabilities	**159,221**	218,165
Total liabilities	**14,061,684**	13,788,235
Stockholders equity:		
Preferred stock, $1 par value		
Authorized and unissued 2,000,000 shares		
Common stock, $5 par value		
Authorized 100,000,000 shares; issued 70,465,922 shares	**352,330**	352,330
Capital surplus	**422,189**	427,421
Retained earnings	**756,014**	683,176
Treasury stock of 1,367,512 shares in 2007 and 422,468 shares in 2006, at cost	**(65,904)**	(20,613)
Accumulated other comprehensive loss	**(6,942)**	(200)
Total stockholders equity	**1,457,687**	1,442,114
Total liabilities and stockholders equity	**$ 15,519,371**	$ 15,230,349

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)	**For the Three Months Ended June 30**		**For the Six Months Ended June 30**	
	2007	2006	**2007**	2006
		(Unaudited)		
INTEREST INCOME				
Interest and fees on loans	**$ 183,736**	$ 155,672	**$ 360,279**	$ 300,285
Interest and fees on loans held for sale	**6,185**	5,516	**12,265**	10,777
Interest on investment securities	**36,370**	36,261	**74,789**	73,391
Interest on federal funds sold and securities purchased under agreements to resell	**6,517**	1,801	**13,742**	3,424
Total interest income	**232,808**	199,250	**461,075**	387,877
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	**29,812**	23,002	**57,449**	42,609
Time open and C.D. s of less than $100,000	**27,671**	19,448	**54,236**	36,179
Time open and C.D. s of $100,000 and over	**19,566**	13,906	**36,479**	27,093
Interest on federal funds purchased and securities sold under agreements to repurchase	**18,621**	14,024	**43,744**	26,605
Interest on other borrowings	**3,274**	2,391	**3,824**	5,177
Total interest expense	**98,944**	72,771	**195,732**	137,663
Net interest income	**133,864**	126,479	**265,343**	250,214
Provision for loan losses	**9,054**	5,672	**17,215**	10,104
Net interest income after provision for loan losses	**124,810**	120,807	**248,128**	240,110
NON-INTEREST INCOME				
Deposit account charges and other fees	**30,081**	28,910	**56,592**	56,407
Bank card transaction fees	**25,855**	23,558	**48,938**	45,266
Trust fees	**19,972**	17,992	**38,625**	35,811
Trading account profits and commissions	**1,440**	2,010	**3,301**	4,575
Consumer brokerage services	**3,332**	2,771	**6,375**	5,160
Loan fees and sales	**2,712**	2,745	**3,997**	6,488

Other	**10,667**	10,193	**20,515**	21,517
Total non-interest income	**94,059**	88,179	**178,343**	175,224
INVESTMENT SECURITIES GAINS (LOSSES), NET	**(493)**	3,284	**3,402**	5,687
NON-INTEREST EXPENSE				
Salaries and employee benefits	**76,123**	71,239	**153,023**	142,964
Net occupancy	**10,843**	10,230	**22,633**	21,207
Equipment	**5,681**	6,071	**12,114**	12,020
Supplies and communication	**8,586**	7,872	**17,092**	16,265
Data processing and software	**12,149**	12,631	**23,380**	25,024
Marketing	**4,859**	4,657	**9,177**	8,975
Other	**18,108**	16,850	**35,349**	33,056
Total non-interest expense	**136,349**	129,550	**272,768**	259,511
Income before income taxes	**82,027**	82,720	**157,105**	161,510
Less income taxes	**26,453**	27,387	**50,035**	53,233
NET INCOME	**$ 55,574**	$ 55,333	**$ 107,070**	$ 108,277
Net income per share basic	**$ .80**	$ .79	**$ 1.54**	$ 1.54
Net income per share diluted	**$ .79**	$ .78	**$ 1.52**	$ 1.52

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands, except per share data)	**Common Stock**	**Capital Surplus**	**Retained Earnings**	**Treasury Stock**	**Accumulated Other Comprehensive Income (Loss)**	**Total**
			(Unaudited)			
Balance January 1, 2007	**$ 352,330**	**$ 427,421**	**$ 683,176**	**$ (20,613)**	**$ (200)**	**$ 1,442,114**
Net income			**107,070**			**107,070**
Change in unrealized gain (loss) on available for sale securities, net of tax					**(6,971)**	**(6,971)**
Amortization of pension loss, net of tax					**229**	**229**
Total comprehensive income						**100,328**
Purchase of treasury stock				**(91,584)**		**(91,584)**
Issuance of stock under purchase and equity compensation plans		**(7,197)**		**16,005**		**8,808**
Net tax benefit related to equity compensation plans		**1,644**				**1,644**
Stock based compensation		**2,995**				**2,995**
Issuance of nonvested stock awards		**(2,371)**		**2,371**		
Cash dividends paid ($.500 per share)			**(34,678)**			**(34,678)**
Issuance in South Tulsa Financial Corp. acquisition		**(303)**		**27,917**		**27,614**
Adoption of FIN 48			**446**			**446**
Balance June 30, 2007	**$ 352,330**	**$ 422,189**	**$ 756,014**	**$ (65,904)**	**$ (6,942)**	**$ 1,457,687**
Balance January 1, 2006	$ 347,049	$ 388,552	$ 693,021	$ (86,901)	$ (3,883)	$ 1,337,838
Net income			108,277			108,277

Change in unrealized gain (loss) on available for sale securities, net of tax					(13,548)	(13,548)
Total comprehensive income						94,729
Purchase of treasury stock				(75,773)		(75,773)
Issuance of stock under purchase and equity compensation plans		(4,943)		9,408		4,465
Net tax benefit related to equity compensation plans		747				747
Stock based compensation		2,079				2,079
Issuance of nonvested stock awards		(1,077)		1,077		
Cash dividends paid ($.467 per share)			(32,690)			(32,690)
Balance June 30, 2006	$ 347,049	$ 385,358	$ 768,608	$ (152,189)	$ (17,431)	$ 1,331,395

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	For the Six Months Ended June 30 **2007**	2006
	(Unaudited)	
OPERATING ACTIVITIES:		
Net income	**$ 107,070**	$ 108,277
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	**17,215**	10,104
Provision for depreciation and amortization	**25,849**	23,219
Amortization of investment security premiums, net	**3,911**	6,209
Investment securities gains, net[(A)]	**(3,402)**	(5,687)
Net gains on sales of loans held for sale	**(2,373)**	(4,889)
Originations of loans held for sale	**(184,214)**	(166,857)
Proceeds from sales of loans held for sale	**206,446**	242,192
Net (increase) decrease in trading securities, including amounts in the course of settlement	**(55,015)**	2,156
Stock based compensation	**2,995**	2,079
(Increase) decrease in interest receivable	**1,465**	(1,574)
Increase in interest payable	**3,730**	9,897
Increase in income taxes payable	**1,918**	8,691
Net tax benefit related to equity compensation plans	**(1,644)**	(747)
Other changes, net	**(11,262)**	6,213
Net cash provided by operating activities	**112,689**	239,283
INVESTING ACTIVITIES:		
Net cash and cash equivalents received in acquisition	**10,771**	
Proceeds from sales of investment securities[(A)]	**5,541**	17,528
Proceeds from maturities/pay downs of investment securities[(A)]	**582,224**	562,754
Purchases of investment securities[(A)]	**(350,874)**	(277,268)
Net increase in loans	**(446,888)**	(561,317)
Purchases of land, buildings and equipment	**(29,170)**	(16,614)
Sales of land, buildings and equipment	**2,619**	1,690
Net cash used in investing activities	**(225,777)**	(273,227)

FINANCING ACTIVITIES:		
Net decrease in non-interest bearing demand, savings, interest checking and money market deposits	**(157,462)**	(87,709)
Net increase in time open and C.D. s	**291,226**	314,937
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	**(276,678)**	260,084
Additional long-term borrowings	**300,000**	
Repayment of long-term borrowings	**(18,450)**	(124,390)
Purchases of treasury stock	**(91,584)**	(75,773)
Issuance of stock under stock purchase and equity compensation plans	**8,808**	4,465
Net tax benefit related to equity compensation plans	**1,644**	747
Cash dividends paid on common stock	**(34,678)**	(32,690)
Net cash provided by financing activities	**22,826**	259,671
Increase (decrease) in cash and cash equivalents	**(90,262)**	225,727
Cash and cash equivalents at beginning of year	**1,154,316**	674,135
Cash and cash equivalents at June 30	**$ 1,064,054**	$ 899,862
(A) Available for sale and non-marketable securities		
Income tax payments, net of refunds	**$ 46,942**	$ 44,460
Interest paid on deposits and borrowings	**$ 191,764**	$ 127,766

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007 (Unaudited)

1. Principles of Consolidation and Presentation

The accompanying consolidated financial statements include the accounts of Commerce Bancshares, Inc. and all majority-owned subsidiaries (the Company). The consolidated financial statements in this report have not been audited. All significant intercompany accounts and transactions have been eliminated. Certain reclassifications were made to 2006 data to conform to current year presentation. In the opinion of management, all adjustments necessary to present fairly the financial position and the results of operations for the interim periods have been made. All such adjustments are of a normal recurring nature. The results of operations for the three and six month periods ended June 30, 2007 are not necessarily indicative of results to be attained for the full year or any other interim periods.

The significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the 2006 Annual Report on Form 10-K.

2. Acquisitions

The Company completed its previously announced acquisition of South Tulsa Financial Corporation (South Tulsa) on April 1, 2007, and South Tulsa s results of operations were included in the Company s consolidated financial results beginning on that date. In this transaction, the Company acquired the outstanding stock of South Tulsa and issued 561,951 shares of Company stock valued at $27.6 million. The valuation of Company stock was based on the average closing price of Company stock during the measurement period of March 21 through March 27. The Company s acquisition of South Tulsa added $114.7 million in loans, $103.9 million in deposits and two branch locations in Tulsa, Oklahoma. Intangible assets recognized as a result of the transaction consisted of approximately $11.4 million in goodwill and $2.7 million in core deposit premium.

On July 1, 2007, the Company completed its previously announced acquisition of Commerce Bank in Denver, Colorado. In this transaction, the Company acquired the outstanding stock of Commerce Bank for $29.5 million in cash. The acquisition added $74.5 million in loans, $72.2 million in deposits and the Company s first location in Colorado. Intangible assets recognized as a result of the transaction consisted primarily of goodwill and core deposit premium of approximately $21.3 million.

3. Loans and Allowance for Loan Losses

Major classifications within the Company s loan portfolio at June 30, 2007 and December 31, 2006 are as follows.

(In thousands)	**June 30 2007**	December 31 2006
Business	**$ 3,080,804**	$ 2,860,692
Real estate construction	**712,206**	658,148
Real estate business	**2,187,301**	2,148,195
Real estate personal	**1,533,943**	1,478,669

Consumer	**1,567,897**	1,435,038
Home equity	**442,294**	441,851
Credit card	**675,953**	648,326
Overdrafts	**25,523**	10,601
Total loans	**$ 10,225,921**	$ 9,681,520

Included in the table above are impaired loans amounting to $37,076,000 at June 30, 2007 and $18,236,000 at December 31, 2006. Impaired loans include loans on non-accrual status and other loans classified as substandard and more than 60 days past due. Loans acquired in the South Tulsa transaction

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with evidence of a deterioration in credit quality were not material to the consolidated financial statements of the Company. Accordingly, the provisions of AICPA Statement of Position 03-3, which require special accounting for such loans, were not applied.

In addition to its basic portfolio, the Company originates other held for sale loans which it intends to sell in secondary markets. Loans held for sale amounted to $258,563,000 at June 30, 2007 compared to $278,598,000 at December 31, 2006. These loans consist mainly of student loans, amounting to $247,353,000 at June 30, 2007, in addition to $11,210,000 of certain fixed rate residential mortgage loans.

The following is a summary of the allowance for loan losses.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands)	**2007**	2006	**2007**	2006
Balance, beginning of period	**$ 131,730**	$ 128,468	**$ 131,730**	$ 128,447
Additions:				
Allowance for loan losses of acquired bank	**1,228**		**1,228**	
Provision for loan losses	**9,054**	5,672	**17,215**	10,104
Total additions	**10,282**	5,672	**18,443**	10,104
Deductions:				
Loan losses	**13,888**	9,223	**26,281**	18,569
Less recoveries on loans	**4,836**	3,529	**9,068**	8,464
Net loan losses	**9,052**	5,694	**17,213**	10,105
Balance, June 30	**$ 132,960**	$ 128,446	**$ 132,960**	$ 128,446

4. Investment Securities

Investment securities, at fair value, consist of the following at June 30, 2007 and December 31, 2006.

(In thousands)	**June 30 2007**	December 31 2006

Available for sale:		
U.S. government and federal agency obligations	**$ 9,754**	$ 9,651
Government-sponsored enterprise obligations	**380,430**	464,567
State and municipal obligations	**592,541**	594,824
Mortgage-backed securities	**1,732,541**	1,782,443
Other asset-backed securities	**233,727**	354,465
Other debt securities	**23,379**	36,009
Equity securities	**156,938**	173,481
Total available for sale	**3,129,310**	3,415,440
Trading	**19,600**	6,676
Non-marketable	**92,213**	74,207
Total investment securities	**$ 3,241,123**	$ 3,496,323

Available for sale equity securities included short-term investments in money market mutual funds of $40,660,000 at June 30, 2007 and $59,973,000 at December 31, 2006. Equity securities also included common and preferred stock held by the Parent with a fair value of $95,392,000 at June 30, 2007 and $107,840,000 at December 31, 2006.

Non-marketable securities included Federal Home Loan Bank stock and Federal Reserve Bank stock held for debt and regulatory purposes, which totaled $49,165,000 and $35,592,000 at June 30, 2007 and December 31, 2006, respectively. Also included were venture capital and private equity investments, which amounted to $42,968,000 and $38,548,000 at June 30, 2007 and December 31, 2006, respectively. During the first six months of 2007 and 2006, net gains of $3,328,000 and $5,003,000, respectively, were recognized on venture capital and private equity investments. The net gains consisted of both realized gains and losses and fair value adjustments.

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At June 30, 2007, securities carried at $2.0 billion were pledged to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowing capacity at the Federal Reserve. Securities pledged under agreements pursuant to which the collateral may be sold or re-pledged by the secured parties approximated $526.5 million, while securities pledged under agreements pursuant to which the secured parties may not sell or re-pledge the collateral approximated $1.5 billion at June 30, 2007.

5. Goodwill and Other Intangible Assets

The following table presents information about the Company s intangible assets which have estimable useful lives.

	June 30, 2007			December 31, 2006		
(In thousands)	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Amount**	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortizable intangible assets:						
Core deposit premium	**$ 20,162**	**$ (2,831)**	**$ 17,331**	$ 19,920	$ (1,093)	$ 18,827
Mortgage servicing rights	**1,338**	**(617)**	**721**	1,338	(532)	806
Total	**$ 21,500**	**$ (3,448)**	**$ 18,052**	$ 21,258	$ (1,625)	$ 19,633

Aggregate amortization expense on intangible assets was $887,000 and $3,000, respectively, for the three month periods ended June 30, 2007 and 2006, and $1,823,000 and $4,000 for the six month periods ended June 30, 2007 and 2006. The following table shows the estimated future amortization expense based on existing asset balances and the interest rate environment as of June 30, 2007. The Company s actual amortization expense in any given period may be different from the estimated amounts depending upon the addition of new intangible assets, changes in mortgage interest rates, pre-payment rates and other market conditions.

(In thousands)	
2007	$ 3,611
2008	3,316
2009	2,896
2010	2,480
2011	2,067

Changes in the carrying amount of goodwill and net other intangible assets for the six month period ended June 30, 2007 are as follows. Additional intangible assets were acquired in the South Tulsa transaction, and adjustments were

recorded to intangible assets acquired in prior years, mainly due to the finalization of core deposit premium valuation analyses.

(In thousands)	Goodwill	Core Deposit Premium	Mortgage Servicing Rights
Balance at December 31, 2006	$ 97,643	$ 18,827	$ 806
Current year acquisition	11,364	2,732	
Adjustments to prior year acquisitions	1,698	(2,490)	
Amortization		(1,738)	(85)
Balance at June 30, 2007	$ 110,705	$ 17,331	$ 721

6. Guarantees

The Company, as a provider of financial services, routinely issues financial guarantees in the form of financial and performance standby letters of credit. Standby letters of credit are contingent commitments

issued by the Company generally to guarantee the payment or performance obligation of a customer to a third party. While these represent a potential outlay by the Company, a significant amount of the commitments may expire without being drawn upon. The Company has recourse against the customer for any amount it is required to pay to a third party under a standby letter of credit. The letters of credit are subject to the same credit policies, underwriting standards and approval process as loans made by the Company. Most of the standby letters of credit are secured and in the event of nonperformance by the customers, the Company has rights to the underlying collateral, which could include commercial real estate, physical plant and property, inventory, receivables, cash and marketable securities.

Upon issuance of standby letters of credit, the Company recognizes a liability for the fair value of the obligation undertaken, which is estimated to be equivalent to the amount of fees to be received from the customer over the life of the agreement. At June 30, 2007 that net liability was $5,522,000, which will be accreted into income over the remaining life of the respective commitments. The contractual amount of these letters of credit, which represents the maximum potential future payments guaranteed by the Company, was $466,297,000 at June 30, 2007.

The Company guarantees payments to holders of certain trust preferred securities issued by wholly owned grantor trusts. Preferred securities issued by Breckenridge Capital Trust I, amounting to $4,000,000, are due in 2030 and may be redeemed beginning in 2010. These securities have a 10.875% interest rate throughout their term. Securities issued by West Pointe Statutory Trust I, amounting to $10,000,000, are due in 2034 and may be redeemed beginning in 2009. These securities have a variable interest rate based on LIBOR, which resets on a quarterly basis. The maximum potential future payments guaranteed by the Company, which includes future interest and principal payments through maturity, was estimated to be approximately $44,793,000 at June 30, 2007. At June 30, 2007, the Company had a recorded liability of $14,179,000 in principal and accrued interest to date, representing amounts owed to the security holders.

In 2007, the Company entered into a risk participation agreement (RPA) with another financial institution which mitigates that institution s credit risk arising from an interest rate swap with a third party. The RPA stipulates that, in the event of default by the third party on the interest rate swap, the Company will reimburse a portion of the loss borne by the financial institution. The Company s exposure is based on a notional amount of $9,934,000. At inception, the Company recorded a liability which represented the fair value of the RPA, which is being accreted to income over the seven year term of the RPA, given no adverse change in the third party s creditworthiness. At June 30, 2007 the liability was $68,000. The maximum potential future payment guaranteed by the Company cannot be readily estimated, but is dependent upon the fair value of the interest rate swap at the time of default. If an event of default had occurred at June 30, 2007, the Company would not have been required to make a payment.

7. Pension

The amount of net pension cost (income) is as follows:

	For the Three Months Ended June 30		**For the Six Months Ended June 30**	
(In thousands)	**2007**	2006	**2007**	2006
Service cost benefits earned during the period	**$ 247**	$ 276	**$ 495**	$ 552
Interest cost on projected benefit obligation	**1,146**	1,191	**2,291**	2,382

Expected return on plan assets		**(1,705)**		(1,800)		**(3,410)**		(3,600)
Amortization of unrecognized net loss		**185**		257		**370**		515
Net periodic pension cost (income)	**$**	**(127)**	$	(76)	**$**	**(254)**	$	(151)

Substantially all benefits under the Company s defined benefit pension plan were frozen effective January 1, 2005. During the first six months of 2007, the Company made no funding contributions to its defined benefit pension plan, and made minimal funding contributions to a supplemental executive retirement plan (the CERP), which carries no segregated assets. The Company has no plans to make any further contributions, other than those related to the CERP, during the remainder of 2007. The higher income

recognized for the defined benefit pension plan in the three and six month periods ended June 30, 2007 compared to the same periods in 2006 was primarily due to the greater than expected return on plan assets for the year ended September 30, 2006 (the valuation date).

Recently issued accounting pronouncements required the Company to reflect the funded status of its defined benefit pension plan on its consolidated balance sheet at December 31, 2006. Accordingly, the Company recorded a pre-tax reduction in accumulated other comprehensive income of $17,532,000, consisting of accumulated net loss, on that date. During the first six months of 2007, $370,000 of accumulated net loss was recognized as a component of net periodic benefit cost, as shown above, and as an increase in other comprehensive income.

8. Common Stock

Presented below is a summary of the components used to calculate basic and diluted earnings per share.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands, except per share data)	**2007**	2006	**2007**	2006
Basic earnings per share:				
Net income available to common shareholders	**$ 55,574**	$ 55,333	**$ 107,070**	$ 108,277
Weighted average basic common shares outstanding	**69,285**	69,879	**69,457**	70,108
Basic earnings per share	**$ .80**	$ .79	**$ 1.54**	$ 1.54
Diluted earnings per share:				
Net income available to common shareholders	**$ 55,574**	$ 55,333	**$ 107,070**	$ 108,277
Weighted average common shares outstanding	**69,285**	69,879	**69,457**	70,108
Net effect of nonvested stock and the assumed exercise of stock-based awards based on the treasury stock method using the average market price for the respective periods	**782**	954	**822**	969
Weighted average diluted common shares outstanding	**70,067**	70,833	**70,279**	71,077
Diluted earnings per share	**$ .79**	$ .78	**$ 1.52**	$ 1.52

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9. Other Comprehensive Income (Loss)

The Company s components of other comprehensive income (loss) consist of the unrealized holding gains and losses on available for sale investment securities and the amortization of accumulated pension loss which has been recognized in net periodic benefit cost.

	For the Three Months Ended June 30		For the Six Months Ended June 30	
(In thousands)	**2007**	2006	**2007**	2006
Available for sale investment securities:				
Unrealized holding gains (losses)	**$ (21,106)**	$ (5,109)	**$ (11,135)**	$ (21,851)
Reclassification adjustment for gains included in net income	**(77)**		**(75)**	
Net unrealized gains (losses) on securities	**(21,183)**	(5,109)	**(11,210)**	(21,851)
Income tax expense (benefit)	**(8,050)**	(1,941)	**(4,239)**	(8,303)
Holding gains (losses) on investment securities	**(13,133)**	(3,168)	**(6,971)**	(13,548)
Prepaid pension cost:				
Amortization of accumulated pension loss	**185**		**370**	
Income tax expense (benefit)	**(71)**		**(141)**	
Accumulated pension loss	**114**		**229**	
Other comprehensive income (loss)	**$ (13,019)**	$ (3,168)	**$ (6,742)**	$ (13,548)

10. Segments

The Company segregates financial information for use in assessing its performance and allocating resources among three operating segments. The Consumer segment includes the retail branch network, consumer finance, bankcard, student loans and discount brokerage services. The Commercial segment provides corporate lending, leasing, and international services, as well as business, government deposit and cash management services. The Money Management segment provides traditional trust and estate tax planning services, and advisory and discretionary investment management services.

The following table presents selected financial information by segment and reconciliations of combined segment totals to consolidated totals. There were no material intersegment revenues among the three segments. Management periodically makes changes to methods of assigning costs and income to its business

segments to better reflect operating results. If appropriate, these changes are reflected in prior year information presented below.

(In thousands)	Consumer	Commercial	Money Management	Segment Totals	Other/ Elimination	Consolidated Totals
Three Months Ended June 30, 2007:						
Net interest income	**$ 98,450**	**$ 55,629**	**$ 2,566**	**$ 156,645**	**$ (22,781)**	**$ 133,864**
Provision for loan losses	**8,028**	**1,040**		**9,068**	**(14)**	**9,054**
Non-interest income	**48,194**	**20,908**	**22,661**	**91,763**	**2,296**	**94,059**
Investment securities losses, net					**(493)**	**(493)**
Non-interest expense	**76,636**	**39,198**	**15,401**	**131,235**	**5,114**	**136,349**
Income before income taxes	**$ 61,980**	**$ 36,299**	**$ 9,826**	**$ 108,105**	**$ (26,078)**	**$ 82,027**
Three Months Ended June 30, 2006:						
Net interest income	$ 93,255	$ 51,662	$ 2,410	$ 147,327	$ (20,848)	$ 126,479
Provision for loan losses	5,320	393		5,713	(41)	5,672
Non-interest income	45,738	19,444	21,169	86,351	1,828	88,179
Investment securities gains, net					3,284	3,284
Non-interest expense	71,934	36,397	14,938	123,269	6,281	129,550
Income before income taxes	$ 61,739	$ 34,316	$ 8,641	$ 104,696	$ (21,976)	$ 82,720
Six Months Ended June 30, 2007:						
Net interest income	**$ 195,736**	**$ 111,087**	**$ 4,768**	**$ 311,591**	**$ (46,248)**	**$ 265,343**
Provision for loan losses	**15,925**	**1,261**		**17,186**	**29**	**17,215**
Non-interest income	**88,744**	**40,976**	**44,566**	**174,286**	**4,057**	**178,343**
Investment securities gains, net					**3,402**	**3,402**
Non-interest expense	**151,135**	**78,448**	**31,557**	**261,140**	**11,628**	**272,768**
Income before income taxes	**$ 117,420**	**$ 72,354**	**$ 17,777**	**$ 207,551**	**$ (50,446)**	**$ 157,105**

Six Months Ended June 30, 2006:					
Net interest income	$ 181,664	$ 101,344	$ 5,034	$ 288,042	$ (37,828)	$ 250,214
Provision for loan losses	10,967	(854)		10,113	(9)	10,104
Non-interest income	89,219	38,613	42,855	170,687	4,537	175,224
Investment securities gains, net					5,687	5,687
Non-interest expense	143,064	71,881	30,650	245,595	13,916	259,511
Income before income taxes	$ 116,852	$ 68,930	$ 17,239	$ 203,021	$ (41,511)	$ 161,510

The information presented above was derived from the internal profitability reporting system used by management to monitor and manage the financial performance of the Company. This information is based on internal management accounting policies, which have been developed to reflect the underlying economics of the businesses. The policies address the methodologies applied in connection with funds transfer pricing and assignment of overhead costs among segments. Funds transfer pricing was used in the determination of net interest income by assigning a standard cost (credit) for funds used (provided) by assets and liabilities based on their maturity, prepayment and/or repricing characteristics.

The performance measurement of the operating segments is based on the management structure of the Company and is not necessarily comparable with similar information for any other financial institution. The information is also not necessarily indicative of the segments financial condition and results of operations if they were independent entities.

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11. Derivative Instruments

The Company s interest rate risk management strategy includes the ability to modify the re-pricing characteristics of certain assets and liabilities so that changes in interest rates do not adversely affect the net interest margin and cash flows. Interest rate swaps are used on a limited basis as part of this strategy. At June 30, 2007, the Company had entered into two interest rate swaps with a notional amount of $13,832,000, which are designated as fair value hedges of certain fixed rate loans. The Company also sells swap contracts to customers who wish to modify their interest rate sensitivity. These swaps are offset by matching contracts purchased by the Company from other financial institutions. Because of the matching terms of the offsetting contracts, the effect of these transactions on net income is minimal. The notional amount of these types of swaps at June 30, 2007 was $275,511,000. These swaps are accounted for as free-standing derivatives and changes in their fair value were recorded in other non-interest income.

Through its International Department, the Company enters into foreign exchange contracts consisting mainly of contracts to purchase or deliver foreign currencies for customers at specific future dates. Also, mortgage loan commitments and forward sales contracts result from the Company s mortgage banking operation, in which fixed rate personal real estate loans are originated and sold to other institutions.

The Company s derivative instruments are listed below.

	June 30, 2007			December 31, 2006		
(In thousands)	**Notional Amount**	**Positive Fair Value**	**Negative Fair Value**	Notional Amount	Positive Fair Value	Negative Fair Value
Interest rate contracts:						
Swap contracts	**$ 289,343**	**$ 2,495**	**$ (3,260)**	$ 181,464	$ 1,185	$ (2,003)
Option contracts	**6,970**	**4**	**(4)**	6,970	10	(10)
Credit-related contracts	**9,934**		**(68)**			
Foreign exchange contracts:						
Forward contracts	**8,862**	**273**	**(271)**	16,117	29	(20)
Option contracts	**2,820**	**4**	**(4)**	2,670	16	(16)
Mortgage loan commitments	**7,909**	**12**	**(25)**	11,529		(43)
Mortgage loan forward sale contracts	**20,018**	**205**	**(13)**	21,269	60	(14)
Total	**$ 345,856**	**$ 2,993**	**$ (3,645)**	$ 240,019	$ 1,300	$ (2,106)

12. Income Taxes

For the second quarter of 2007, income tax expense amounted to $26,453,000 compared to $27,387,000 in the second quarter of 2006. The effective income tax rate for the Company was 32.2% in the current quarter compared to 33.1% in the same quarter last year. For the six months ended June 30, 2007 and 2006, income tax expense amounted to $50,035,000 and $53,233,000, resulting in effective income tax rates of 31.8% and 33.0%, respectively.

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Upon adoption of FIN 48, the Company recognized a $446,000 decrease to the liability for unrecognized tax benefits which, as required, was accounted for as an increase to the January 1, 2007 balance of retained earnings. The resulting amount of unrecognized tax benefits at January 1, 2007 was $2,379,000, which included $444,000 of related accrued interest and penalties.

The Company recognizes interest and penalties related to unrecognized tax benefits within income tax expense in the consolidated statements of income.

The Company s federal income tax returns for 2003 through 2006 remain subject to examination by the Internal Revenue Service. Its state tax returns for 2002 through 2006 remain subject to examination by various state jurisdictions, based on individual state statutes of limitations.

13. Stock-Based Compensation

During the first six months of 2007, stock-based compensation was issued in the form of stock appreciation rights (SARs) and nonvested stock. The stock-based compensation expense that has been charged against income was $1,477,000 and $1,280,000 in the three months ended June 30, 2007 and 2006, respectively, and $2,995,000 and $2,079,000 in the six months ended June 30, 2007 and 2006, respectively.

The Company s adoption of SFAS No. 123R, Share-Based Payment (the Statement), on January 1, 2006 resulted in a $543,000 reduction in stock-based compensation expense, which was recorded at the adoption date. This adjustment resulted from a change by the Company from its former policy of recognizing the effect of forfeitures only as they occurred to the Statement s requirement to estimate the number of outstanding instruments for which the requisite service is not expected to be rendered.

In determining compensation cost, the Black-Scholes option-pricing model is used to estimate the fair value of SARs and options on date of grant. SARs and stock options are granted with an exercise price equal to the market price of the Company s stock at the date of grant and have 10-year contractual terms. SARs, which were granted for the first time in 2006, vest on a graded basis over 4 years of continuous service. All SARs must be settled in stock under provisions of the plan. Stock options, which were granted in 2005 and previous years, vest on a graded basis over 3 years of continuous service. The table below shows the fair values of SARs granted during the first six months of 2007 and 2006, including the model assumptions for those grants.

	Six Months Ended June 30	
	2007	2006
Weighted per share average fair value at grant date	**$12.56**	$13.41
Assumptions:		
Dividend yield	**1.9%**	1.7%
Volatility	**19.9%**	21.1%
Risk-free interest rate	**4.6%**	4.6%
Expected term (in years)	**7.4 years**	7.4 years

A summary of option activity during the first six months of 2007 is presented below.

Weighted

(Dollars in thousands, except per share data)	Shares	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2007	3,225,100	$ 33.14		
Granted				
Cancelled	(2,207)	43.16		
Exercised	(343,668)	28.12		
Outstanding at June 30, 2007	2,879,225	$ 33.73	4.9 years	$ 33,302

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A summary of SAR activity during the first six months of 2007 is presented below.

(Dollars in thousands, except per share data)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2007	477,009	$ 49.29		
Granted	473,950	49.50		
Cancelled	(14,822)	49.13		
Exercised				
Outstanding at June 30, 2007	936,137	$ 49.40	9.1 years	$

A summary of the status of the Company s nonvested share awards, as of June 30, 2007, and changes during the six month period then ended is presented below.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2007	167,560	$ 41.09
Granted	51,141	48.75
Vested	(17,694)	33.38
Forfeited	(3,361)	45.15
Nonvested at June 30, 2007	197,646	$ 43.69

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes and with the statistical information and financial data appearing in this report as well as the Company s 2006 Annual Report on Form 10-K. Results of operations for the three and six month periods ended June 30, 2007 are not necessarily indicative of results to be attained for any other period.

Forward Looking Information

This report may contain forward-looking statements that are subject to risks and uncertainties and include information about possible or assumed future results of operations. Many possible events or factors could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from those expressed in the forward-looking statements. Words such as expects , anticipates , believes , estimates , variatio of such words and other similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in, or implied by, such forward-looking statements. Readers should not rely solely on the forward-looking statements and should consider all uncertainties and risks discussed throughout this report. Forward-looking statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made or to reflect the occurrence of unanticipated events. Such possible events or factors include: changes in economic conditions in the Company s market area, changes in policies by regulatory agencies, governmental legislation and regulation, fluctuations in interest rates, changes in liquidity requirements, demand for loans in the Company s market area, and competition with other entities that offer financial services.

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Critical Accounting Policies

The Company s consolidated financial statements are prepared based on the application of certain accounting policies, some of which require numerous estimates and strategic or economic assumptions that may prove inaccurate or be subject to variations which may significantly affect the Company s reported results and financial position for the current period or future periods. The use of estimates, assumptions, and judgments are necessary when financial assets and liabilities are required to be recorded at, or adjusted to reflect, fair value. Assets and liabilities carried at fair value inherently result in more financial statement volatility. Fair values and the information used to record valuation adjustments for certain assets and liabilities are based on either quoted market prices or are provided by other independent third-party sources, when available. When such information is not available, management estimates valuation adjustments primarily by using internal cash flow and other financial modeling techniques. Changes in underlying factors, assumptions, or estimates in any of these areas could have a material impact on the Company s future financial condition and results of operations.

The Company has identified several policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the allowance for loan losses, the valuation of certain non-marketable investments, and accounting for income taxes.

The Company performs periodic and systematic detailed reviews of its loan portfolio to assess overall collectability. The level of the allowance for loan losses reflects the Company s estimate of the losses inherent in the loan portfolio at any point in time. While these estimates are based on substantive methods for determining allowance requirements, actual outcomes may differ significantly from estimated results, especially when determining allowances for business, lease, construction and business real estate loans. These loans are normally larger and more complex, and their collection rates are harder to predict. Personal loans, including personal mortgage, credit card and consumer loans, are individually smaller and perform in a more homogenous manner, making loss estimates more predictable. Further discussion of the methodologies used in establishing the allowance is provided in the Provision and Allowance for Loan Losses section of this discussion.

The Company, through its direct holdings and its Small Business Investment subsidiaries, has numerous private equity and venture capital investments, which totaled $43.0 million at June 30, 2007. These private equity and venture capital securities are reported at fair value. The values assigned to these securities where no market quotations exist are based upon available information and management s judgment. Although management believes its estimates of fair value reasonably reflect the fair value of these securities, key assumptions regarding the projected financial performance of these companies, the evaluation of the investee company s management team, and other economic and market factors may affect the amounts that will ultimately be realized from these investments.

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity s financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company s financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences, including the effects of IRS examinations and examinations by other state agencies, could materially impact the Company s financial position and its results of operations. Further discussion of income taxes is presented in the Income Taxes section of this discussion.

Selected Financial Data

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	**2007**	2006
Per Share Data				
Net income basic	**$ .80**	$ .79	**$ 1.54**	$ 1.54
Net income diluted	**.79**	.78	**1.52**	1.52
Cash dividends	**.250**	.233	**.500**	.467
Book value			**21.12**	19.12
Market price			**45.30**	47.67
Selected Ratios				
(Based on average balance sheets)				
Loans to deposits*	**87.73%**	84.27%	**87.75%**	83.80%
Non-interest bearing deposits to total deposits	**5.43**	6.06	**5.39**	5.80
Equity to loans*	**14.04**	14.48	**14.14**	14.62
Equity to deposits	**12.31**	12.21	**12.41**	12.26
Equity to total assets	**9.62**	9.69	**9.59**	9.70
Return on total assets	**1.46**	1.61	**1.42**	1.59
Return on total stockholders equity	**15.12**	16.59	**14.77**	16.37
(Based on end-of-period data)				
Non-interest income to revenue**	**41.27**	41.08	**40.20**	41.19
Efficiency ratio***	**59.43**	60.35	**61.07**	61.00
Tier I capital ratio			**10.65**	11.51
Total capital ratio			**11.89**	12.85
Leverage ratio			**8.94**	9.47

* *Includes loans held for sale.*
** *Revenue includes net interest income and non-interest income.*
*** *The efficiency ratio is calculated as non-interest expense (excluding intangibles amortization) as a percent of revenue.*

Results of Operations

Summary

(Dollars in thousands)	Three Months Ended June 30			Six Months Ended June 30		
	2007	2006	% Change	**2007**	2006	% Change
Net interest income	**$ 133,864**	$ 126,479	5.8%	**$ 265,343**	$ 250,214	6.0%
Provision for loan losses	**(9,054)**	(5,672)	59.6	**(17,215)**	(10,104)	70.4

Non-interest income	**94,059**	88,179	6.7	**178,343**	175,224	1.8
Investment securities gains (losses), net	**(493)**	3,284	(115.0)	**3,402**	5,687	(40.2)
Non-interest expense	**(136,349)**	(129,550)	5.2	**(272,768)**	(259,511)	5.1
Income taxes	**(26,453)**	(27,387)	(3.4)	**(50,035)**	(53,233)	(6.0)
Net income	**$ 55,574**	$ 55,333	.4%	**$ 107,070**	$ 108,277	(1.1)%

For the quarter ended June 30, 2007, net income amounted to $55.6 million, an increase of $241 thousand, or .4%, over the second quarter of the previous year. For the current quarter, the annualized return on average assets was 1.46%, the annualized return on average equity was 15.12%, and the efficiency ratio was 59.43%. Compared to the second quarter of last year, net interest income increased 5.8%, mainly due to

loan growth and higher yields. Non-interest income grew 6.7%, with increases in bank card, deposit account and trust fee income. Net gains reported on securities transactions and valuations declined $3.8 million. The provision for loan losses amounted to $9.1 million for the quarter, a $3.4 million increase over the second quarter of last year. Non-interest expense grew by 5.2%, with most of the increase related to salaries and employee benefits. Diluted earnings per share was $.79, an increase of 1.3% over $.78 per share in the second quarter of 2006.

Net income for the first six months of 2007 was $107.1 million, a $1.2 million, or 1.1%, decrease from the first six months of 2006. For the first six months of 2007, the annualized return on average assets was 1.42%, the annualized return on average equity was 14.77%, and the efficiency ratio was 61.07%. The decrease in net income was primarily due to a 5.1% increase in non-interest expense and a $7.1 million increase in the provision for loan losses. These effects were partly offset by a 6.0% increase in net interest income and a 1.8% increase in non-interest income. Diluted earnings per share of $1.52 for the first six months of 2007 was unchanged from the same period in the prior year.

Effective April 1, 2007, the Company completed the acquisition of South Tulsa Financial Corporation (South Tulsa). In this transaction, the Company acquired the outstanding stock of South Tulsa and issued 561,951 shares of Company stock valued at $27.6 million. The Company s acquisition of South Tulsa added $114.7 million in loans, $103.9 million in deposits and two branch locations in Tulsa, Oklahoma. Goodwill of $11.4 million and core deposit premium of $2.7 million were recorded in this transaction.

In the third quarter of 2006, the Company acquired certain assets and assumed certain liabilities of Boone National Savings and Loan Association in central Missouri through a purchase and assumption agreement. Loans and deposits of $126.4 million and $100.9 million, respectively, were acquired, and goodwill and core deposit premium of $15.6 million and $2.6 million, respectively, were recorded as a result of this transaction. During the same quarter, the Company acquired the outstanding stock of West Pointe Bancorp, Inc. in Belleville, Illinois, which added $508.8 million in assets (including $255.0 million in loans) and $381.8 million in deposits. Goodwill of $38.7 million and core deposit premium of $14.9 million were recorded in this transaction.

On July 1, 2007, the Company completed the acquisition of Commerce Bank in Denver, Colorado. In this transaction, the Company acquired the outstanding stock of Commerce Bank for $29.5 million in cash. The acquisition added $74.5 million in loans, $72.2 million in deposits and the Company s first location in Colorado.

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Net Interest Income

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates. Changes not solely due to volume or rate changes are allocated to rate.

Analysis of Changes in Net Interest Income

	Three Months Ended June 30, 2007 vs. 2006			**Six Months Ended June 30, 2007 vs. 2006**		
	Change due to			**Change due to**		
(In thousands)	**Average Volume**	**Average Rate**	**Total**	**Average Volume**	**Average Rate**	**Total**
Interest income, fully taxable equivalent basis:						
Loans	$ 20,795	$ 7,489	$ 28,284	$ 40,387	$ 19,963	$ 60,350
Loans held for sale	1,148	(479)	669	773	715	1,488
Investment securities:						
U.S. government and federal agency securities	(2,476)	522	(1,954)	(5,323)	993	(4,330)
State and municipal obligations	2,764	287	3,051	6,494	688	7,182
Mortgage and asset-backed securities	(1,631)	2,051	420	(3,475)	4,717	1,242
Other securities	(756)	(130)	(886)	(1,550)	102	(1,448)
Total interest on investment securities	(2,099)	2,730	631	(3,854)	6,500	2,646
Federal funds sold and securities purchased under agreements to resell	4,367	349	4,716	9,049	1,269	10,318
Total interest income	24,211	10,089	34,300	46,355	28,447	74,802
Interest expense:						
Deposits:						
Savings	13	(14)	(1)	31	(9)	22
Interest checking and money market	2,294	4,517	6,811	3,305	11,513	14,818
Time open & C.D. s of less than $100,000	3,685	4,538	8,223	7,478	10,579	18,057
Time open & C.D. s of $100,000 and over	3,446	2,214	5,660	4,176	5,210	9,386
Total interest on deposits	9,438	11,255	20,693	14,990	27,293	42,283

Federal funds purchased and securities sold under agreements to repurchase	2,126	2,471	4,597	9,645	7,494	17,139
Other borrowings	959	(79)	880	(1,163)	(193)	(1,356)
Total interest expense	12,523	13,647	26,170	23,472	34,594	58,066
Net interest income, fully taxable equivalent basis	$ 11,688	$ (3,558)	$ 8,130	$ 22,883	$ (6,147)	$ 16,736

Net interest income in the second quarter of 2007 amounted to $133.9 million, which increased $7.4 million, or 5.8%, compared to the second quarter of last year. The growth in net interest income was the result of loan growth, coupled with higher average rates earned on loans. These increases were partially offset by an increase in average rates paid on interest bearing deposits and higher levels of deposits and

borrowings. During the second quarter of 2007, the net yield on earning assets (tax equivalent) was 3.82%, compared with 3.98% in the same quarter last year. For the first six months of 2007, net interest income totaled $265.3 million, a $15.1 million increase over net interest income of $250.2 million in the first six months of 2006. The net yield on earning assets declined by 15 basis points during the first six months of 2007 to 3.83%, compared with 3.98% in the same period last year.

Total interest income increased $33.6 million, or 16.8%, over the second quarter of 2006. The increase was the result of higher loan interest income, which grew $28.3 million on a tax equivalent basis (excluding loans held for sale), or 18.1%. The growth in loan interest income was mainly due to an increase of $1.2 billion in average loan balances outstanding, which included increases of $440.4 million in business loans, $227.4 million in business real estate loans, $148.8 million in personal real estate loans, and $185.8 million in consumer loans. Also, overall average rates earned on the loan portfolio increased 29 basis points and contributed $7.5 million in tax equivalent interest income. The second quarter of 2007 included the effects of bank acquisitions during the third quarter of 2006 and the second quarter of 2007, which contributed average loan growth of $454.3 million and related loan income of $8.6 million in the second quarter of 2007. The second quarter of 2006 included a $1.3 million increase to loan income, resulting from the Company s decision at that time to classify its student loan portfolio as held for sale and to cease amortization of deferred costs related to those loans. Total interest income was also slightly impacted by the level and yields of the investment securities portfolio. Average yields rose 40 basis points during the second quarter of 2007 compared to the second quarter of 2006, which contributed $2.7 million in tax equivalent income. This increase was partly offset by lower average balances in the securities portfolio. While the total portfolio declined $242.2 million on average compared to the second quarter of 2006, investments in state and municipal securities rose from 9.9% of the portfolio in the second quarter of 2006 to 18.3% in the second quarter of 2007 and contributed $3.1 million on a tax equivalent basis. The average tax equivalent yield on interest earning assets was 6.60% in the second quarter of 2007 compared to 6.25% in the second quarter of 2006.

Compared to the first six months of 2006, total interest income increased $73.2 million, or 18.9%. The increase reflects similar trends as noted in the quarterly comparison above, with higher average rates earned on higher loan balances, contributing an increase of $60.4 million in tax equivalent interest income. The rate increase was the result of increases in the federal funds rate ordered earlier in 2006 by the Federal Reserve. Securities interest income in the first six months of 2007 compared to the prior period rose $2.6 million on a tax equivalent basis, due mainly to higher yields. Average yields on securities rose 45 basis points over the prior period, partly offset by a $225.9 million decline in average balances, as proceeds from maturities and pay downs were shifted to fund loan growth. Interest earned on overnight investments in federal funds sold and resale agreements rose $10.3 million over the prior period, primarily due to a $387.6 million increase in average balances. The average tax equivalent yield on total interest earning assets for the six months was 6.61% in 2007 and 6.14% in 2006.

Total interest expense increased $26.2 million, or 36.0%, compared to the second quarter of 2006. This increase was mainly the result of growth in deposit interest expense of $20.7 million, due to a 53 basis point increase in average rates paid, in addition to a $1.0 billion increase in average interest bearing deposit balances. Average rates paid on overnight borrowings increased 44 basis points, along with a $257.9 million increase in average borrowings, causing interest expense on federal funds purchased and securities sold under agreements to repurchase to increase $4.6 million. The average rate paid on all interest bearing liabilities increased to 3.04% in the second quarter of 2007 compared to 2.49% in the second quarter of 2006.

For the first six months of 2007, total interest expense increased $58.1 million, or 42.2%, compared with the previous year. Most of the growth was due to higher deposit interest expense of $42.3 million. Both higher interest bearing deposit balances, which rose $889.7 million, and higher rates paid, which rose 60 basis points, contributed to the increase. Interest expense on overnight borrowings grew $17.1 million, which was due to both higher balances and higher rates paid. The overall average cost of total interest bearing liabilities was 3.03% for the first six months of

2007 compared to 2.37% for the same period in 2006.

Summaries of average assets and liabilities and the corresponding average rates earned/paid appear on the last page of this discussion.

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Non-Interest Income

The estimated fair value of the contingent consideration payments is determined using an option pricing model. The estimated value of the contingent consideration is based upon available information and certain assumptions, known at the time of this report, which management believes are reasonable. Any differences in the actual contingent consideration payments after the final determination of purchase price will be recorded in operating income (expense) in the consolidated statements of operations and comprehensive income.

The acquisition has been accounted for as a business combination. The preliminary allocation of purchase price to the assets acquired and liabilities assumed is as follows (in thousands):

	Preliminary Fair Value
Net working capital	$ 305
Fixed assets	106
Intangible assets	8,700
Goodwill	11,535
Net deferred tax liabilities	(2,659)
Total preliminary purchase price	$ 17,987

The Company primarily used the income approach for the valuation as appropriate, and used valuation inputs in these models and analyses that were based on market participant assumptions. Market participants are buyers and sellers unrelated to the Company and fair value is determined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the measurement date.

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The acquired intangible assets are definite-lived assets consisting primarily of developed technology, customer relationships and trademarks and tradenames. The estimated fair values of the developed technology were determined using excess earnings analysis, the customer relationships were determined using cost savings analysis and the trademarks and tradenames were determined using relief from royalty analysis. The fair value of the intangible assets with definite lives are as follows (dollars in thousands):

	Preliminary Fair Value	Weighted Average Amortization Life
Technology	$ 6,000	7 years
Customer lists	1,700	1 year
Trademarks and tradenames	1,000	4 years
Total intangible assets	$ 8,700	5.5 years

As of June 30, 2018, the Company has not completed its determination of the final purchase price or the final allocation of the purchase price to the assets and liabilities of the acquisition. The purchase price and final allocation of purchase price is expected to be finalized in the third quarter of 2018. Any adjustment to the preliminary purchase price or the assets and liabilities assumed with the acquisition will adjust goodwill.

The Company recorded preliminary goodwill of $11.5 million, which represents the excess of the purchase price over the estimated fair value of tangible and intangible assets acquired, net of the liabilities assumed. The goodwill is primarily attributable to Ovation as a going concern, which represents the ability of the Company to earn a higher return on the collection of assets and business of Ovation than if those assets and business were to be acquired and managed separately. The benefit of access to the workforce is an additional element of goodwill. The goodwill is recorded in the Company’s one reportable segment. For income tax purposes, the acquisition was an equity purchase and the goodwill will not be tax deductible.

Subsequent to the acquisition date, the Company’s consolidated results of operations include the results of the acquired Ovation business. In both of the second quarter and first six months of 2018, revenue of $0.5 million and immaterial net loss from continuing operations have been included in the Company’s consolidated results of operations.

Acquisition-related costs were $0.3 million in both of the second quarter and first six months of 2018, and are included in general and administrative expense on the consolidated statement of operations and comprehensive income.

Changes in Contingent Consideration

CompareCards

On November 16, 2016, the Company acquired all of the membership interests of Iron Horse Holdings, LLC, which does business under the name CompareCards ("CompareCards"). CompareCards is an online marketing platform for credit cards, which the Company is utilizing to grow its existing credit card business. The acquisition has been accounted for as a business combination. During 2017, the Company finalized the determination of the purchase price allocation with respect to the assets acquired and liabilities assumed.

The Company paid $80.7 million in initial cash consideration and agreed to make two earnout payments, each up to $22.5 million, based on the amount of earnings before interest, taxes, depreciation and amortization CompareCards generates during the periods of January 1, 2017 through December 31, 2017 and January 1, 2018 through December 31, 2018, or up to $45.0 million in aggregate payments. The purchase price for the acquisition is $103.8 million comprised of an upfront cash payment of $80.7 million on November 16, 2016 and $23.1 million for the estimated fair value of the earnout payments at the time of closing the acquisition. In the first quarter of 2018, the Company paid $22.5 million related to the earnout payment for the period of January 1, 2017 through December 31, 2017, which is included within cash flows from financing activities on the consolidated statement of cash flows. In the second quarter of 2018, the Company paid $22.5 million related to the earnout payment for the period of January 1, 2018 through December 31, 2018, of which $0.6 million is included within cash flows from financing activities and

$21.9 million is included within cash flows from operating activities on the consolidated statement of cash flows. During the second quarter and first six months of 2018, the Company recorded $0.2 million and $0.7 million, respectively, of contingent consideration expense within operating income in the consolidated statement of operations and comprehensive income due to the change in estimated fair value of the earnout payments.

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DepositAccounts
On June 14, 2017, the Company acquired substantially all of the assets of Deposits Online, LLC, which does business under the name DepositAccounts.com (“DepositAccounts”). DepositAccounts is a leading consumer-facing media property in the depository industry and is one of the most comprehensive sources of depository deals and analysis on the Internet, covering all major deposit product categories through editorial content, programmatic rate tables and user-generated content. The acquisition has been accounted for as a business combination. During 2017, the Company finalized the determination of the purchase price allocation with respect to the assets acquired and liabilities assumed. The Company paid $24.0 million of initial cash consideration and could make additional contingent consideration payments of up to $9.0 million. The potential contingent consideration payments are comprised of (i) up to seven payments of $1.0 million each based on specified increases in Federal Funds interest rates during the period commencing on the closing date and ending on June 30, 2020 and (ii) a one-time performance payment of up to $2.0 million based on the net revenue of deposit products during the period of January 1, 2018 through December 31, 2018. These additional payments, to the extent earned, will be payable in cash. The purchase price for the acquisition is $29.0 million, comprised of the upfront cash payment of $24.0 million and $5.0 million for the estimated fair value of the contingent consideration at the time of closing the acquisition.
In the third quarter of 2017, the Company made a payment of $1.0 million associated with a specified increase in the Federal Funds rate in June 2017. In each of the first and second quarters of 2018, the Company paid $1.0 million associated with specified increases in the Federal Funds rate in December 2017 and March 2018, respectively, which are included within cash flows from financing activities on the consolidated statement of cash flows. As of June 30, 2018, the estimated fair value of the contingent consideration totaled $5.3 million, of which $4.4 million is included in current contingent consideration and $0.9 million is included in non-current contingent consideration in the accompanying consolidated balance sheet. The estimated fair value of the portion of the contingent consideration payments based on increases in interest rates is determined using a scenario approach based on the interest rate forecasts of Federal Open Market Committee participants. The estimated fair value of the portion of the contingent consideration payments potentially earned based on net revenue is determined using an option pricing model. The estimated value of the contingent consideration is based upon available information and certain assumptions, known at the time of this report, which management believes are reasonable. Any differences in the actual contingent consideration payments will be recorded in operating income in the consolidated statements of operations and comprehensive income. During the second quarter and first six months of 2018, the Company recorded $0.4 million and $1.3 million, respectively, of contingent consideration expense in the consolidated statement of operations and comprehensive income due to the change in estimated fair value of the contingent consideration.
In July 2018, the Company paid $1.0 million associated with a specified increase in the Federal Funds rate in June 2018.
SnapCap
On September 19, 2017, the Company acquired certain assets of Snap Capital LLC, which does business under the name SnapCap (“SnapCap”). SnapCap, a tech-enabled online platform, connects business owners with lenders offering small business loans, lines of credit and merchant cash advance products through a concierge-based sales approach. The acquisition has been accounted for as a business combination. During 2017, the Company finalized the determination of the purchase price allocation with respect to the assets acquired and liabilities assumed.
The Company paid $11.9 million of initial cash consideration and could make up to three additional contingent consideration payments, each ranging from zero to $3.0 million, based on certain defined operating results during the periods of October 1, 2017 through September 30, 2018, October 1, 2018 through September 30, 2019 and October 1, 2019 through March 31, 2020. These additional payments, to the extent earned, will be payable in cash. The purchase price for the acquisition is $18.2 million, comprised of the upfront cash payment of $11.9 million and $6.3 million for the estimated fair value of the contingent consideration.

As of June 30, 2018, the estimated fair value of the contingent consideration totaled $4.1 million, of which $2.9 million is included in current contingent consideration and $1.2 million is included in non-current contingent consideration in the accompanying consolidated balance sheet. The estimated fair value of the contingent consideration payments is determined using an option pricing model. The estimated value of the contingent consideration is based upon available information and certain assumptions, known at the time of this report, which management believes are reasonable. Any differences in the actual contingent consideration payments will be recorded in operating income in the consolidated statements of operations and comprehensive income. During the second quarter and first six months of 2018, the Company recorded gains of $0.8 million and $2.9 million,

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

respectively, in the consolidated statement of operations and comprehensive income due to the change in estimated fair value of the contingent consideration.

Pro forma Financial Results

The unaudited pro forma financial results for the second quarters and first six months of 2017 and 2018 combine the consolidated results of the Company and DepositAccounts, SnapCap, Ovation and Camino Del Avion (Delaware), LLC ("MagnifyMoney") giving effect to the acquisitions as if the DepositAccounts, MagnifyMoney and SnapCap acquisitions had been completed on January 1, 2016 and as if the Ovation acquisition had been completed on January 1, 2017. This unaudited pro forma financial information is presented for informational purposes only and is not indicative of future operations or results had the acquisitions been completed as of January 1, 2016 or 2017, or any other date.

The unaudited pro forma financial results include adjustments for additional amortization expense based on the fair value of the intangible assets with definite lives and their estimated useful lives. The provision for income taxes from continuing operations has also been adjusted to reflect taxes on the historical results of operations of DepositAccounts and SnapCap. DepositAccounts and SnapCap did not pay taxes at the entity level as these entities were limited liability companies whose members elected for them to be taxed as a partnership.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(in thousands)			
Pro forma revenue	$185,820	$158,737	$369,201	$296,935
Pro forma net income from continuing operations	$45,188	$7,758	$80,956	$14,966

The unaudited pro forma net income from continuing operations in the second quarter and first six months of 2018 includes the aggregate after tax contingent consideration gain associated with the CompareCards, DepositAccounts and SnapCap earnouts of $0.1 million and $0.7 million, respectively. The unaudited pro forma net income from continuing operations in the second quarter and first six months of 2017 includes the after tax contingent consideration expense associated with the CompareCards earnouts of $5.6 million and $10.9 million, respectively.

The unaudited pro forma net income from continuing operations for the first six months of 2017 has been adjusted to include acquisition-related costs of $0.3 million incurred by the Company that are directly attributable to the Ovation acquisition, which will not have an ongoing impact. Accordingly, these acquisition-related costs have been eliminated from the unaudited pro forma net income from continuing operations for the second quarter and first six months of 2018. Acquisition-related costs incurred by the Company, DepositAccounts and MagnifyMoney that are directly attributable to the DepositAccounts and MagnifyMoney acquisitions, and which will not have an on-going impact, have been eliminated from the unaudited pro forma net income from continuing operations for the second quarter and first six months of 2017.

NOTE 7—ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following (in thousands):

	June 30, 2018	December 31, 2017
Accrued litigation liabilities	$32	$ 346
Accrued advertising expense	36,588	40,727
Accrued compensation and benefits	8,938	7,679
Accrued professional fees	774	2,072
Customer deposits and escrows	5,546	5,564
Contribution to LendingTree Foundation	10,000	10,000

Other	8,843	10,795
Total accrued expenses and other current liabilities	$70,721	$ 77,183

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 8—SHAREHOLDERS' EQUITY

Basic and diluted income per share was determined based on the following share data (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Weighted average basic common shares	12,416	11,965	12,254	11,896
Effect of stock options	1,176	1,557	1,363	1,564
Effect of dilutive share awards	135	82	177	92
Effect of Convertible Senior Notes and warrants	420	—	733	—
Weighted average diluted common shares	14,147	13,604	14,527	13,552

For each of the three and six months ended June 30, 2018, the weighted average shares that were anti-dilutive, and therefore excluded from the calculation of diluted income per share, included options to purchase 0.4 million shares of common stock.

The 0.625% Convertible Senior Notes due June 1, 2022 and the warrants issued by the Company in the second quarter of 2017 could be converted into the Company's common stock in the future, subject to certain contingencies. See Note 11—Debt for additional information. Shares of the Company's common stock associated with these instruments were excluded from the calculation of diluted income per share for the three and six months ended June 30, 2017, as they were anti-dilutive since the conversion price of the Convertible Senior Notes and the strike price of the warrants were greater than the average market price of the Company's common stock during the second quarter of 2017. Other than the shares associated with the 0.625% Convertible Senior Notes and the warrants, no shares related to potentially dilutive securities were excluded from the calculation of diluted income per share for the three and six months ended June 30, 2017.

Common Stock Repurchases

In each of January 2010, May 2014, January 2016, February 2016 and February 2018, the board of directors authorized and the Company announced the repurchase of up to $10.0 million, $10.0 million, $50.0 million, $40.0 million and $100.0 million, respectively, of LendingTree's common stock. During the six months ended June 30, 2018, the Company purchased 156,731 shares of its common stock pursuant to this stock repurchase program. At June 30, 2018, approximately $81.7 million of the previous authorizations to repurchase common stock remain available for the Company to purchase its common stock.

NOTE 9—STOCK-BASED COMPENSATION

Non-cash compensation related to equity awards is included in the following line items in the accompanying consolidated statements of operations and comprehensive income (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Cost of revenue	$79	$45	$137	$88
Selling and marketing expense	1,433	692	2,934	1,177
General and administrative expense	8,490	1,601	17,229	2,820
Product development	1,176	562	1,987	1,045
Total non-cash compensation	$11,178	$2,900	$22,287	$5,130

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock Options

A summary of changes in outstanding stock options is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value[a]
		(per option)	(in years)	(in thousands)
Options outstanding at January 1, 2018	1,863,739	$ 30.70		
Granted [b]	52,148	328.73		
Exercised	(723,510)	17.84		
Forfeited	(2,682)	267.28		
Expired	—	—		
Options outstanding at June 30, 2018	1,189,695	51.05	4.66	$ 200,359
Options exercisable at June 30, 2018	1,010,061	$ 20.03	3.87	$ 195,761

(a) The aggregate intrinsic value represents the total pre-tax intrinsic value (the difference between the Company's closing stock price of $213.80 on the last trading day of the quarter ended June 30, 2018 and the exercise price, multiplied by the number of shares covered by in-the-money options) that would have been received by the option holder had the option holder exercised these options on June 30, 2018. The intrinsic value changes based on the market value of the Company's common stock.

(b) During the six months ended June 30, 2018, the Company granted stock options to certain employees and members of the board of directors with a weighted average grant date fair value per share of $167.11, calculated using the Black-Scholes option pricing model, which vesting periods include (a) immediate vesting on grant date (b) one year from grant date (c) two years from the grant date, (d) three years from the grant date and (e) four years from the grant date.

For purposes of determining stock-based compensation expense, the weighted average grant date fair value per share of the stock options was estimated using the Black-Scholes option pricing model, which requires the use of various key assumptions. The weighted average assumptions used are as follows:

Expected term [1]	5.00 - 6.34 years
Expected dividend [2]	—
Expected volatility [3]	50% - 53%
Risk-free interest rate [4]	2.33% - 2.90%

(1) The expected term of stock options granted was calculated using the "Simplified Method," which utilizes the midpoint between the weighted average time of vesting and the end of the contractual term. This method was utilized for the stock options due to a lack of historical exercise behavior by the Company's employees.

(2) For all stock options granted in 2018, no dividends are expected to be paid over the contractual term of the stock options, resulting in a zero expected dividend rate.

(3) The expected volatility rate is based on the historical volatility of the Company's common stock.

(4) The risk-free interest rate is specific to the date of grant. The risk-free interest rate is based on U.S. Treasury yields for notes with comparable expected terms as the awards, in effect at the grant date.

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock Options with Performance Conditions

A summary of the changes in outstanding stock options with performance conditions is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value[(a)]
		(per option)	(in years)	(in thousands)
Options outstanding at January 1, 2018	37,877	$ 308.90		
Granted	—	—		
Exercised	—	—		
Forfeited	—	—		
Expired	—	—		
Options outstanding at June 30, 2018	37,877	$ 308.90	9.45	$ —
Options exercisable at June 30, 2018	—	$ —	0	$ —

(a) The aggregate intrinsic value represents the total pre-tax intrinsic value (the difference between the Company's closing stock price of $213.80 on the last trading day of the quarter ended June 30, 2018 and the exercise price, multiplied by the number of shares covered by in-the-money options) that would have been received by the option holder had the option holder exercised these options on June 30, 2018. The intrinsic value changes based on the market value of the Company's common stock.

Restricted Stock Units

A summary of the changes in outstanding nonvested restricted stock units ("RSUs"), exclusive of RSUs granted to the Chairman and Chief Executive Officer in 2018 described below, is as follows:

	RSUs	
	Number of Units	Weighted Average Grant Date Fair Value (per unit)
Nonvested at January 1, 2018	152,829	$ 121.68
Granted	54,538	336.59
Vested	(57,736)	94.67
Forfeited	(4,734)	187.56
Nonvested at June 30, 2018	144,897	$ 211.18

Restricted Stock Units with Performance Conditions

A summary of the changes in outstanding nonvested RSUs with performance conditions is as follows:

	RSUs with Performance Conditions	
	Number of Units	Weighted Average Grant Date Fair Value

		(per unit)
Nonvested at January 1, 2018	111,205	$ 160.34
Granted	—	—
Vested	(12,226)	106.18
Forfeited	(2,652)	113.22
Nonvested at June 30, 2018	96,327	$ 168.52

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Chairman and Chief Executive Officer Grants

2017 Grants

On July 25, 2017, the Company’s Compensation Committee approved new compensation arrangements for its Chairman and Chief Executive Officer. The new compensation arrangements include the issuance of performance based equity compensation grants with a modeled total grant date value of $87.5 million of which 25% (119,015 shares) would be in the form of time-vested restricted stock awards with a performance condition and 75% (a maximum of 769,376 shares) would be in the form of performance-based nonqualified stock options.

The performance-based nonqualified stock options have a target number of shares that vest upon achieving targeted total shareholder return performance of 110% stock price appreciation and a maximum number of shares for achieving superior performance up to 167% of the target number of shares. No shares will vest unless 70% of the targeted performance is achieved. Time-based service vesting conditions would also have to be satisfied in order for performance-vested shares to become fully vested and no longer subject to forfeiture. On July 26, 2017, an initial grant of performance-based nonqualified stock options with a target number of shares of 402,694 and a maximum number of shares of 672,499 were issued with an exercise price of $183.80, the closing stock price on July 26, 2017. The performance measurement period ends on September 30, 2022. The fair value of the performance-based stock options will be recognized on a straight-line basis through the vest date of September 30, 2022, whether or not any of the total shareholder return targets are met.

The Company's Fifth Amended and Restated 2008 Stock and Annual Incentive Plan (the "2008 Plan") imposes a per employee upper annual grant limit of 672,500 shares. As a result, the remaining 58,010 target performance-based nonqualified stock options and potential performance-based restricted stock awards were awarded on January 2, 2018. The form of the awards consisted of 31,336 performance-based nonqualified stock options with a per share exercise price of $340.25, and 26,674 performance-based restricted stock awards, substituting for an equal number of the performance-based options, to compensate for the increase in the exercise price of the performance-based option granted on July 26, 2017. These performance-based nonqualified stock options and performance-based restricted stock awards were issued with respective total grant date fair values of $9.5 million and $1.9 million.

As of June 30, 2018, performance-based nonqualified stock options of 312,008 and performance-based restricted stock awards of 19,175 had been earned, which have a vest date of September 30, 2022.

On January 2, 2018, the 119,015 time-vested restricted stock awards with a performance condition were granted. The terms of these awards were fixed in the approved new compensation agreements in July 2017 with a total grant date fair value of $21.9 million. The performance condition was tied to the Company's operating results during the first six months of 2018, and has been met. During the six months ended June 30, 2018, 35,703 of these awards vested.

2018 Grants

On February 16, 2018, the Company’s Compensation Committee approved the issuance of performance based equity compensation grants to its Chairman and Chief Executive Officer with a modeled total grant date value of $7.5 million, of which 50% (9,896 shares) would be in the form of time-vested restricted stock units and 50% (a maximum of 21,982 shares) would be in the form of performance-based nonqualified stock options. On February 16, 2018, the 9,896 time-vested restricted stock units were granted with a grant date fair value of $378.95.

The performance-based nonqualified stock options have a target number of shares that vest upon achieving targeted total shareholder return performance of 81% stock price appreciation and a maximum number of shares for achieving superior performance up to 167% of the target number of shares. No shares will vest unless 41% of the targeted performance is achieved. Time-based service vesting conditions would also have to be satisfied in order for performance-vested shares to become fully vested and no longer subject to forfeiture. On February 16, 2018, the performance-based nonqualified stock options with a target number of shares of 13,163 and a maximum number of shares of 21,982 were issued with an exercise price of $378.95, the closing stock price on February 16, 2018. The performance measurement period ends on March 31, 2022. The fair value of the performance-based stock options will

be recognized on a straight-line basis through the vest date of March 31, 2022, whether or not any of the total shareholder return targets are met. As of June 30, 2018, the performance targets associated with the performance-based nonqualified stock options had not been met.

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In the three and six months ended June 30, 2018, the Company recorded $5.4 million and $10.7 million, respectively, in stock-based compensation expense related to the 2017 and 2018 grants to its Chairman and Chief Executive Officer in the consolidated statement of operations and comprehensive income.

A summary of changes in outstanding stock options with market conditions is as follows:

	Number of Options with Market Conditions	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value[(a)]
		(per option)	(in years)	(in thousands)
Options outstanding at January 1, 2018	402,694	$ 183.80		
Granted [(b)]	44,499	351.70		
Exercised	—	—		
Forfeited	—	—		
Expired	—	—		
Options outstanding at June 30, 2018	447,193	200.51	9.12	$ 12,081
Options exercisable at June 30, 2018	—	$ —	0	$ —

(a) The aggregate intrinsic value represents the total pre-tax intrinsic value (the difference between the Company's closing stock price of $213.80 on the last trading day of the quarter ended June 30, 2018 and the exercise price, multiplied by the number of shares covered by in-the-money options) that would have been received by the option holder had the option holder exercised these options on June 30, 2018. The intrinsic value changes based on the market value of the Company's common stock.

(b) During the six months ended June 30, 2018, the Company granted stock options with a weighted average grant date fair value per share of $296.80, calculated using the Monte Carlo simulation model, which have vesting dates of March 31, 2022 and September 30, 2022.

For purposes of determining stock-based compensation expense, the weighted average grant date fair value per share of the stock options was estimated using the Monte Carlo simulation model, which requires the use of various key assumptions. The weighted average assumptions used are as follows:

Expected term [(1)]	7.00 - 7.15 years
Expected dividend [(2)]	—
Expected volatility [(3)]	50%
Risk-free interest rate [(4)]	2.38% - 2.81%

(1) The expected term of stock options with a market condition granted was calculated using the midpoint between the weighted average time of vesting and the end of the contractual term.

(2) For all stock options with a market condition granted in 2018, no dividends are expected to be paid over the contractual term of the stock options, resulting in a zero expected dividend rate.

(3) The expected volatility rate is based on the historical volatility of the Company's common stock.

(4) The risk-free interest rate is specific to the date of grant. The risk-free interest rate is based on U.S. Treasury yields for notes with comparable expected terms as the awards, in effect at the grant date.

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10—INCOME TAXES

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(in thousands, except percentages)			
Income tax benefit	$29,721	$104	$53,182	$1,183
Effective tax rate	-196.5 %	-1.3 %	-193.2 %	-8.1 %

For the three and six months ended June 30, 2018, the effective tax rate varied from the federal statutory rate of 21% primarily due to a tax benefit of $33.7 million and $60.9 million, respectively, recognized for excess tax benefits due to employee exercises of stock options and vesting of restricted stock in accordance with ASU 2016-09 and the effect of state taxes.

For the three and six months ended June 30, 2017, the effective tax rate varied from the federal statutory rate of 35% primarily due to a tax benefit of $3.8 million and $7.6 million, respectively, recognized for excess tax benefits due to employee exercises of stock options and vesting of restricted stock in accordance with ASU 2016-09.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(in thousands)			
Income tax expense - excluding excess tax benefit on stock compensation	$(3,946)	$(3,736)	$(7,688)	$(6,420)
Excess tax benefit on stock compensation	33,667	3,840	60,870	7,603
Income tax benefit	$29,721	$104	$53,182	$1,183

NOTE 11—DEBT

Convertible Senior Notes

On May 31, 2017, the Company issued $300.0 million aggregate principal amount of its 0.625% Convertible Senior Notes due June 1, 2022 (the “Notes”) in a private placement. The Notes bear interest at a rate of 0.625% per year, payable semi-annually on June 1 and December 1 of each year, beginning on December 1, 2017. The Notes will mature on June 1, 2022, unless earlier repurchased or converted.

The initial conversion rate of the Notes is 4.8163 shares of Common Stock per $1,000 principal amount of Notes (which is equivalent to an initial conversion price of approximately $207.63 per share). The conversion rate will be subject to adjustment upon the occurrence of certain specified events but will not be adjusted for accrued and unpaid interest. In addition, upon the occurrence of a fundamental change prior to the maturity of the Notes, the Company will, in certain circumstances, increase the conversion rate by a specified number of additional shares for a holder that elects to convert the Notes in connection with such fundamental change. Upon conversion, the Notes will settle for cash, shares of the Company’s stock, or a combination thereof, at the Company’s option. It is the intent of the Company to settle the principal amount of the Notes in cash and any conversion premium in shares of its common stock.

The Notes are the Company’s senior unsecured obligations and will rank senior in right of payment to any of the Company’s indebtedness that is expressly subordinated in right of payment to the Notes; equal in right of payment to any of the Company’s unsecured indebtedness that is not so subordinated; effectively junior in right of payment to any of the Company’s secured indebtedness, including borrowings under the senior secured Revolving Credit Facility, described below, to the extent of the value of the assets securing such indebtedness; and structurally junior to all indebtedness and other liabilities (including trade payables) of the Company’s subsidiaries.

Prior to the close of business on the business day immediately preceding February 1, 2022, the Notes will be convertible at the option of the holders thereof only under the following circumstances:

- during any calendar quarter commencing after the calendar quarter ending on September 30, 2017 (and only during such calendar quarter), if the last reported sale price of the common stock for at least 20 trading days (whether or not consecutive)

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

during the 30 consecutive trading day period ending on, and including the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

- during the five business day period after any five consecutive trading day period in which, for each trading day of that period, the trading price (as defined in the Notes) per $1,000 principal amount of Notes for such trading day was less than 98% of the product of the last reported sale price of the Common Stock and the conversion rate on each such trading day; or
- upon the occurrence of specified corporate events including but not limited to a fundamental change.

Holders of the Notes became entitled to convert the Notes on January 1, 2018, based on the last reported sales price of the Company's common stock, for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on December 31, 2017, being greater than or equal to 130% of the conversion price of the Notes on each applicable trading day. Holders of the Notes continued to have such right until June 30, 2018, based on the last reported sales price of the Company's common stock, for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on March 31, 2018, being greater than or equal to 130% of the conversion price of the Notes on each applicable trading day. Holders of the Notes are not entitled to convert the Notes during the calendar quarter ended September 30, 2018 as the last reported sales price of the Company's common stock, for at least 20 trading days (whether or not consecutive) during the period of 30 consecutive trading days ending on June 30, 2018, was not greater than or equal to 130% of the conversion price of the Notes on each applicable trading day.

On or after February 1, 2022, until the close of business on the second scheduled trading day immediately preceding the maturity date of the Notes, holders of the Notes may convert all or a portion of their Notes regardless of the foregoing conditions.

The Company may not redeem the Notes prior to the maturity date and no sinking fund is provided for the Notes. Upon the occurrence of a fundamental change prior to the maturity date of the Notes, holders of the Notes may require the Company to repurchase all or a portion of the Notes for cash at a price equal to 100% of the principal amount of the Notes to be repurchased, plus any accrued and unpaid interest to, but excluding, the fundamental change repurchase date.

If the market price per share of the Common Stock, as measured under the terms of the Notes, exceeds the conversion price of the Notes, the Notes could have a dilutive effect, unless the Company elects, subject to certain conditions, to settle the principal amount of the Notes and any conversion premium in cash.

The initial measurement of convertible debt instruments that may be settled in cash are separated into a debt and equity component whereby the debt component is based on the fair value of a similar instrument that does not contain an equity conversion option. The separate components of debt and equity of the Company’s Notes were determined using an interest rate of 5.36%, which reflects the nonconvertible debt borrowing rate of the Company at the date of issuance. As a result, the initial components of debt and equity were $238.4 million and $61.6 million, respectively. Financing costs related to the issuance of the Notes were approximately $9.3 million of which $7.4 million were allocated to the liability component and are being amortized to interest expense over the term of the debt and $1.9 million were allocated to the equity component.

In the first six months of 2018, the Company recorded interest expense on the Notes of $7.2 million which consisted of $0.9 million associated with the 0.625% coupon rate, $5.6 million associated with the accretion of the debt discount, and $0.7 million associated with the amortization of the debt issuance costs. In the first six months of 2017, the Company recorded interest expense on the Notes of $1.2 million which consisted of $0.2 million associated with the 0.625% coupon rate, $0.9 million associated with the accretion of the debt discount, and $0.1 million associated with the amortization of the debt issuance costs. The debt discount is being amortized over the term of the debt.

As of June 30, 2018, the fair value of the Notes is estimated to be approximately $361.5 million using the Level 1 observable input of the last quoted market price on June 29, 2018.

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the gross carrying amount, unamortized debt cost, debt issuance costs and net carrying value of the liability component of the Notes are as follows (in thousands):

	June 30, 2018	December 31, 2017
Gross carrying amount	$300,000	$ 300,000
Unamortized debt discount	49,579	55,202
Debt issuance costs	5,941	6,599
Net carrying amount	$244,480	$ 238,199

Convertible Note Hedge and Warrant Transactions

On May 31, 2017, in connection with the issuance of the Notes, the Company entered into Convertible Note Hedge (the “Hedge”) and Warrant transactions with respect to the Company’s common stock. The Company used approximately $18.1 million of the net proceeds from the Notes to pay for the cost of the Hedge, after such cost was partially offset by the proceeds from the Warrant transactions.

On May 31, 2017, the Company paid $61.5 million to the counterparties for the Hedge transactions. The Hedge transactions cover approximately 1.4 million shares of the Company’s common stock, the same number of shares initially underlying the Notes, and are exercisable upon any conversion of the Notes. The Hedge Transactions are expected generally to reduce the potential dilution to the Common Stock upon conversion of the Notes and/or offset any cash payments the Company is required to make in excess of the principal amount of the converted Notes, as the case may be, in the event that the market price per share of Common Stock, as measured under the terms of the Hedge transactions, is greater than the strike price of the Hedge transactions, which initially corresponds to the initial conversion price of the Notes, or approximately $207.63 per share of Common Stock. The Hedge transactions will expire upon the maturity of the Notes.

On May 31, 2017, the Company sold to the counterparties, warrants (the "Warrants") to acquire 1.4 million shares of Common Stock at an initial strike price of $266.39 per share, which represents a premium of 70% over the reported sale price of the Common Stock of $156.70 on May 24, 2017. On May 31, 2017, the Company received aggregate proceeds of approximately $43.4 million from the sale of the Warrants.

If the market price per share of the Common Stock, as measured under the terms of the Warrants, exceeds the strike price of the Warrants, the Warrants could have a dilutive effect, unless the Company elects, subject to certain conditions, to settle the Warrants in cash.

The Hedge and Warrant transactions are indexed to, and potentially settled in, the Company's common stock and the net cost of $18.1 million has been recorded as a reduction to additional paid-in capital in the consolidated statement of shareholders’ equity.

Senior Secured Revolving Credit Facility

On November 21, 2017, the Company's wholly-owned subsidiary, LendingTree, LLC, entered into an amended and restated $250.0 million five-year senior secured revolving credit facility which matures on November 21, 2022 (the “Revolving Credit Facility”). The Revolving Credit Facility replaced the Company's previous $125.0 million revolving credit facility. Borrowings under the Revolving Credit Facility can be used to finance working capital needs, capital expenditures and general corporate purposes, including to finance permitted acquisitions. As of June 30, 2018, the Company does not have any borrowings outstanding under the Revolving Credit Facility.

Up to $10.0 million of the Revolving Credit Facility will be available for short-term loans, referred to as swingline loans. Additionally, up to $10.0 million of the Revolving Credit Facility will be available for the issuance of letters of credit. Under certain conditions, the Company will be permitted to add one or more term loans and/or increase revolving commitments under the Revolving Credit Facility by an additional $100.0 million, or a greater amount provided that a total consolidated senior secured debt to EBITDA ratio does not exceed 2.50 to 1.00.

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company’s borrowings under the Revolving Credit Facility bear interest at annual rates that, at the Company’s option, will be either:

- a base rate generally defined as the sum of (i) the greater of (a) the prime rate of SunTrust Bank, (b) the federal funds effective rate plus 0.5% and (c) the LIBO rate (defined below) on a daily basis applicable for an interest period of one month plus 1.0% and (ii) an applicable percentage of 0.25% to 1.0% based on a total consolidated debt to EBITDA ratio; or
- a LIBO rate generally defined as the sum of (i) the rate for Eurodollar deposits in the applicable currency and (ii) an applicable percentage of 1.25% to 2.0% based on a total consolidated debt to EBITDA ratio.

All swingline loans bear interest at the base rate defined above. Interest on the Company’s borrowings are payable quarterly in arrears for base rate loans and on the last day of each interest rate period (but not less often than three months) for LIBO rate loans.

The Revolving Credit Facility contains a restrictive financial covenant, which initially limits the total consolidated debt to EBITDA ratio to 4.5, with step downs to 4.0 over time, except that this may increase by 0.5 for the four fiscal quarters following a material acquisition. In addition, the Revolving Credit Facility contains customary affirmative and negative covenants in addition to events of default for a transaction of this type that, among other things, restrict additional indebtedness, liens, mergers or certain fundamental changes, asset dispositions, dividends, stock repurchases and other restricted payments, transactions with affiliates, sale-leaseback transactions, hedging transactions, loans and investments and other matters customarily restricted in such agreements. The Company was in compliance with all covenants at June 30, 2018.

The Revolving Credit Facility requires LendingTree, LLC to pledge as collateral, subject to certain customary exclusions, substantially all of its assets, including 100% of its equity in all of its domestic subsidiaries and 66% of the voting equity, and 100% of the non-voting equity, in all of its material foreign subsidiaries (of which there are currently none). The obligations under this facility are unconditionally guaranteed on a senior basis by LendingTree, Inc. and material domestic subsidiaries of LendingTree, LLC, which guaranties are secured by a pledge as collateral, subject to certain customary exclusions, of 100% of each such guarantor's assets, including 100% of each such guarantor’s equity in all of its domestic subsidiaries and 66% of the voting equity, and 100% of the non-voting equity, in all of its material foreign subsidiaries (of which there are currently none).

The Company is required to pay an unused commitment fee quarterly in arrears on the difference between committed amounts and amounts actually borrowed under the Revolving Credit Facility equal to an applicable percentage of 0.25% to 0.45% per annum based on a total consolidated debt to EBITDA ratio. The Company is required to pay a letter of credit participation fee and a letter of credit fronting fee quarterly in arrears. The letter of credit participation fee is based upon the aggregate face amount of outstanding letters of credit at an applicable percentage of 1.25% to 2.0% based on a total consolidated debt to EBITDA ratio. The letter of credit fronting fee is 0.125% per annum on the face amount of each letter of credit.

In addition to the remaining unamortized debt issuance costs associated with the original revolving credit facility, debt issuance costs of $1.4 million related to the Revolving Credit Facility are being amortized to interest expense over the life of the Revolving Credit Facility of five years, and are included in prepaid and other current assets and other non-current assets in the Company's consolidated balance sheet.

NOTE 12—CONTINGENCIES

Overview

LendingTree is involved in legal proceedings on an ongoing basis. In assessing the materiality of a legal proceeding, the Company evaluates, among other factors, the amount of monetary damages claimed, as well as the potential impact of non-monetary remedies sought by plaintiffs (e.g., injunctive relief) that may require it to change its business practices in a manner that could have a material and adverse impact on the business. With respect to the matters disclosed in this Note 12, unless otherwise indicated, the Company is unable to estimate the possible loss or range of

losses that could potentially result from the application of such non-monetary remedies.
As of June 30, 2018, the Company had a litigation settlement accrual of $8.0 million in discontinued operations. As of December 31, 2017, the Company had litigation settlement accruals of $0.3 million and $4.0 million in continuing operations and discontinued operations, respectively. The litigation settlement accrual relates to litigation matters that were either settled or a firm offer for settlement was extended, thereby establishing an accrual amount that is both probable and reasonably estimable.

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Specific Matters
Litigation Related to Discontinued Operations
Residential Funding Company
Residential Funding Company, LLC v Home Loan Center, Inc., No. 13-cv-3451 (U.S. Dist. Ct., Minn.). On or about December 16, 2013, Home Loan Center, Inc. was served in the above captioned matter. Generally, Residential Funding Company, LLC ("RFC") seeks damages for breach of contract and indemnification for certain residential mortgage loans as well as residential mortgage-backed securitizations ("RMBS") containing mortgage loans. RFC asserts that, beginning in 2008, RFC faced massive repurchase demands and lawsuits from purchasers or insurers of the loans and RMBS that RFC had sold. RFC filed for bankruptcy protection in May 2012. Plaintiff alleges that, after RFC filed for Chapter 11 protection, hundreds of proofs of claim were filed, many of which mirrored the litigation filed against RFC prior to its bankruptcy.
In December 2013, the United States Bankruptcy Court for the Southern District of New York entered an Order confirming the Second Amended Joint Chapter 11 Plan Proposed by Residential Capital, LLC et al. and the Official Committee of Unsecured Creditors. Plaintiff then began filing substantially similar complaints against approximately 80 of the loan originators from whom RFC had purchased loans, including Home Loan Center, in federal and state courts in Minnesota and New York. In each case, Plaintiff claims that the defendant is liable for a portion of the global settlement in RFC’s bankruptcy.
Plaintiff asserts two claims against HLC: (1) breach of contract based on HLC’s alleged breach of representations and warranties concerning the quality and characteristics of the mortgage loans it sold to RFC (Count One); and (2) contractual indemnification for alleged liabilities, losses, and damages incurred by RFC arising out of purported defects in loans that RFC purchased from HSBC and sold to third parties (Count Two). Plaintiff alleges that the “types of defects” contained in the loans it purchased from HLC included “income misrepresentation, employment misrepresentation, appraisal misrepresentations or inaccuracies, undisclosed debt, and missing or inaccurate documents.”
HLC filed a Motion to Dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure or, in the alternative, a Motion for More Definite Statement under Rule 12(e). On June 25, 2015 the judge denied HLC's motion.
On July 9, 2015, HLC filed its answer to RFC’s complaint, denying the material allegations of the complaint and asserting numerous defenses thereto. The parties filed their respective motions for summary judgment in April 2018; oral arguments with respect to the motions for summary judgment were heard in June 2018. Trial is currently expected to begin in October 2018. Plaintiff is seeking damages of $61.0 million in this action; HLC intends to vigorously defend this action. An estimated liability of $7.0 million for this matter is included in the accompanying consolidated balance sheet as of June 30, 2018.
Lehman Brothers Holdings, Inc.
Lehman Brothers Holdings Inc. v. 1st Advantage Mortgage, LLC et al., Case No. 08-13555 (SCC), Adversary Proceeding No. 16-01342 (SCC) (Bankr. S.D.N.Y.). In February 2016, Lehman Brothers Holdings, Inc. (“LBHI”) filed an Adversary Complaint against Home Loan Center and approximately 149 other defendants (the "Complaint"). The Complaint generally seeks (1) a declaratory judgment that the settlements entered into by LBHI with Fannie Mae and Freddie Mac as part of LBHI's bankruptcy proceedings gave rise to LBHI's contractual indemnification claims against defendants alleged in the Complaint; (2) indemnification from HLC and the other defendants for losses allegedly incurred by LBHI in respect of defective mortgage loans sold by defendants to LBHI or its affiliates; and (3) interest, attorneys' fees and costs incurred by LBHI in the litigation. On March 31, 2017, HLC filed an omnibus motion to dismiss with other defendants. HLC intends to defend this action vigorously. HLC had previously received a demand letter (the "Letter") from LBHI in December 2014 with respect to 64 loans (the “Loans”) that LBHI alleges were sold by HLC to Lehman Brothers Bank, FSB (“LBB”) between 2004 and 2008 pursuant to a loan purchase agreement (the “LPA”) between HLC and LBB. The Letter generally sought indemnification from HLC in accordance with the LPA for

certain claims that LBHI alleged it allowed in its bankruptcy with respect to the Loans. An estimated liability of $1.0 million for this matter is included in the accompanying consolidated balance sheet as of June 30, 2018.

NOTE 13—FAIR VALUE MEASUREMENTS

Other than the 0.625% Convertible Senior Notes and the Warrants, the carrying amounts of the Company's financial instruments are equal to fair value at June 30, 2018. See Note 11—Debt for additional information on the 0.625% Convertible Senior Notes and the Warrants.

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LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contingent consideration payments related to acquisitions are measured at fair value each reporting period using Level 3 unobservable inputs. The changes in the fair value of the Company's Level 3 liabilities during the three and six months ended June 30, 2018 and 2017 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Contingent consideration, beginning of period	$33,108	$31,846	$57,349	$23,100
Transfers into Level 3				
Transfers out of Level 3				
Total net (gains) losses included in earnings (realized and unrealized)	(167)	9,393	(908)	18,139
Purchases, sales and settlements:				
Additions	5,800	4,988	5,800	4,988
Payments	(23,500)		(47,000)	
Contingent consideration, end of period	$15,241	$46,227	$15,241	$46,227

The contingent consideration liability at June 30, 2018 is the estimated fair value of the earnout payments of the DepositAccounts, SnapCap and Ovation acquisitions. The Company will make payments ranging from $1.0 million to $6.0 million based on the achievement of defined milestone and performance targets for DepositAccounts, payments ranging from zero to $9.0 million based on the achievement of certain defined earnings targets for SnapCap, and payments ranging from zero to $8.75 million based on the achievement of certain defined operating metrics for Ovation. See Note 6—Business Acquisition for additional information on the contingent consideration for each of these respective acquisitions.

The significant unobservable inputs used to calculate the fair value of the contingent consideration are estimated future cash flows for the acquisitions, estimated customer growth rates, estimated date and likelihood of an increase in interest rates and the discount rate. Actual results will differ from the projected results and could have a significant impact on the estimated fair value of the contingent considerations. Additionally, as the liability is stated at present value, the passage of time alone will increase the estimated fair value of the liability each reporting period. Any changes in fair value will be recorded in operating income in the consolidated statements of operations and comprehensive income.

NOTE 14—SEGMENT INFORMATION

The Company has one reportable segment.

Mortgage and non-mortgage product revenue is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Mortgage products	$66,948	$71,515	$140,410	$134,453
Non-mortgage products	117,153	81,258	224,726	150,835
Total revenue	$184,101	$152,773	$365,136	$285,288

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 15—DISCONTINUED OPERATIONS
The revenue and net loss reported as discontinued operations in the accompanying consolidated statements of operations and comprehensive income are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	$—	$—	$—	$(750)
Loss before income taxes	$(2,914)	$(1,059)	$(8,399)	$(2,494)
Income tax benefit	612	370	1,764	873
Net loss	$(2,302)	$(689)	$(6,635)	$(1,621)

During the three and six months ended June 30, 2018 and 2017, loss from discontinued operations was primarily due to litigation settlements and contingencies and legal fees associated with ongoing legal proceedings.
LendingTree Loans
On June 6, 2012, the Company sold substantially all of the operating assets of its LendingTree Loans business for $55.9 million in cash to a wholly-owned subsidiary of Discover Financial Services ("Discover"). Discover generally did not assume liabilities of the LendingTree Loans business that arose before the closing date, except for certain liabilities directly related to assets Discover acquired. Of the purchase price received, a portion was deposited in escrow in accordance with the agreement with Discover for certain loan loss obligations that remain with the Company following the sale. During the second quarter of 2018, the remaining funds in escrow were released to the Company in accordance with the terms of the agreement with Discover.
Significant Assets and Liabilities of LendingTree Loans
Upon closing of the sale of substantially all of the operating assets of the LendingTree Loans business on June 6, 2012, LendingTree Loans ceased to originate consumer loans. Liability for losses on previously sold loans will remain with LendingTree Loans and are discussed below.
Loan Loss Obligations
LendingTree Loans sold loans it originated to investors on a servicing-released basis, so the risk of loss or default by the borrower was generally transferred to the investor. However, LendingTree Loans was required by these investors to make certain representations and warranties relating to credit information, loan documentation and collateral. These representations and warranties may extend through the contractual life of the loan. Subsequent to the loan sale, if underwriting deficiencies, borrower fraud or documentation defects are discovered in individual loans, LendingTree Loans may be obligated to repurchase the respective loan or indemnify the investors for any losses from borrower defaults if such deficiency or defect cannot be cured within the specified period following discovery.
HLC, a subsidiary of the Company, continues to be liable for these indemnification obligations, repurchase obligations and premium repayment obligations following the sale of substantially all of the operating assets of its LendingTree Loans business in the second quarter of 2012.
The following table represents the aggregate loans sold, subsequent settlements and remaining unsettled loans.

	Number of Loans	Original Issue Balance
	(in thousands)	(in billions)
Loans sold by HLC	234	$ 38.9
Subsequent settlements	(172)	(28.8)

Remaining unsettled balance as of June 30, 2018	62	$ 10.1

LENDINGTREE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the fourth quarter of 2015, LendingTree Loans completed a settlement agreement for $0.6 million with one of the investors to which it had sold loans. This investor accounted for approximately 10% of the total number of loans sold and 12% of the original issue balance. This settlement related to all existing and future losses on loans sold to this investor.
During the fourth quarter of 2014, LendingTree Loans completed a settlement agreement for $5.4 million with the largest investor to which it had sold loans. This investor accounted for approximately 40% of both the total number of loans sold and the original issue balance. This settlement related to all existing and future losses on loans sold to this investor.
In the second quarter of 2014, LendingTree Loans completed settlements with two buyers of previously purchased loans.
The Company has been negotiating with certain of the remaining secondary market purchasers to settle any existing and future contingent liabilities, but it may not be able to complete such negotiations on acceptable terms, or at all.
Because LendingTree Loans does not service the loans it sold, it does not maintain nor generally have access to the current balances and loan performance data with respect to the individual loans previously sold to investors.
Accordingly, LendingTree Loans is unable to determine, with precision, its maximum exposure for breaches of the representations and warranties it made to the investors that purchased such loans.
The Company uses a settlement discount framework for evaluating the adequacy of the reserve for loan losses. This model estimates lifetime losses on the population of remaining loans originated and sold by LendingTree Loans using actual defaults for loans with similar characteristics and projected future defaults. It also considers the likelihood of claims expected due to alleged breaches of representations and warranties made by LendingTree Loans and the percentage of those claims investors estimate LendingTree Loans may agree to repurchase. A settlement discount factor is then applied to the result of the foregoing to reflect publicly-announced bulk settlements for similar loan types and vintages, the Company's own settlement experience, as well as LendingTree Loans' non-operating status, in order to estimate a range of potential obligation.
The estimated range of remaining loan losses using this settlement discount framework was determined to be $4.3 million to $7.8 million at June 30, 2018. The reserve balance recorded as of June 30, 2018 was $7.6 million.
Management has considered both objective and subjective factors in the estimation process, but given current general industry trends in mortgage loans as well as housing prices and market expectations, actual losses related to LendingTree Loans' obligations could vary significantly from the obligation recorded as of the balance sheet date or the range estimated above.
Additionally, LendingTree has guaranteed certain loans sold to two investors in the event that LendingTree Loans is unable to satisfy its repurchase and warranty obligations related to such loans.
Based on historical experience, it is anticipated that LendingTree Loans will continue to receive repurchase requests and incur losses on loans sold in prior years.
The activity related to loss reserves on previously sold loans is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Loan loss reserve, beginning of period	$7,554	$7,554	$7,554	$6,804
Provisions	—	—	—	750
Charge-offs to reserves	—	—	—	—
Loan loss reserve, end of period	$7,554	$7,554	$7,554	$7,554

The liability for losses on previously sold loans is presented as current liabilities of discontinued operations in the accompanying consolidated balance sheets as of June 30, 2018 and December 31, 2017.

NOTE 16—SUBSEQUENT EVENT

On July 23, 2018, the Company acquired Student Loan Hero, Inc. ("Student Loan Hero") for $60.7 million cash consideration at the closing of the transaction. Student Loan Hero, a personal finance website dedicated to helping student loan borrowers manage their student debt, offers current and former students in-depth financial comparison tools, educational resources, and unbiased, personalized advice.

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

Cautionary Statement Regarding Forward-Looking Information

This report contains "forward-looking statements" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, as amended by the Private Securities Litigation Reform Act of 1995. These forward-looking statements include statements related to our anticipated financial performance, business prospects and strategy; anticipated trends and prospects in the various industries in which our businesses operate; new products, services and related strategies; and other similar matters. These forward-looking statements are based on management's current expectations and assumptions about future events, which are inherently subject to uncertainties, risks and changes in circumstances that are difficult to predict. The use of words such as "anticipates," "estimates," "expects," "projects," "intends," "plans" and "believes," among others, generally identify forward-looking statements.

Actual results could differ materially from those contained in the forward-looking statements. Factors currently known to management that could cause actual results to differ materially from those in forward-looking statements include those matters discussed or referenced in Part II, Item 1A. Risk Factors included elsewhere in this quarterly report and Part I, Item 1A. Risk Factors of the 2017 Annual Report.

Other unknown or unpredictable factors that could also adversely affect our business, financial condition and results of operations may arise from time to time. In light of these risks and uncertainties, the forward-looking statements discussed in this report may not prove to be accurate. Accordingly, you should not place undue reliance on these forward-looking statements, which only reflect the views of LendingTree, Inc.'s management as of the date of this report. We undertake no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to future operating results or expectations, except as required by law.

Company Overview

LendingTree, Inc., is the parent of LendingTree, LLC and several companies owned by LendingTree, LLC. LendingTree operates what we believe to be the leading online loan marketplace for consumers seeking loans and other credit-based offerings. Our online marketplace provides consumers with access to product offerings from our Network Lenders, including mortgage loans, home equity loans and lines of credit, reverse mortgage loans, auto loans, credit cards, deposit accounts, personal loans, student loans, small business loans and other related offerings. In addition, we offer tools and resources, including free credit scores, that facilitate comparison shopping for these loans, deposits and other credit-based offerings. We seek to match consumers with multiple lenders, who can provide them with competing quotes for the product they are seeking. We also serve as a valued partner to lenders seeking an efficient, scalable and flexible source of customer acquisition with directly measurable benefits, by matching the consumer inquiries we generate with these lenders.

Our My LendingTree platform offers a personalized loan comparison-shopping experience by providing free credit scores and credit score analysis. This platform enables us to observe consumers' credit profiles and then identify and alert them to loan and other credit-based opportunities on our marketplace that may be more favorable than the loans they may have at a given point in time. This is designed to provide consumers with measurable savings opportunities over their lifetimes.

In addition to operating our core mortgage business, we are focused on growing our non-mortgage lending businesses and developing new product offerings and enhancements to improve the experiences that consumers and lenders have as they interact with us. By expanding our portfolio of loans and other product offerings, we are growing and diversifying our business and sources of revenue. We intend to capitalize on our expertise in performance marketing, product development and technology, and to leverage the widespread recognition of the LendingTree brand to effect this strategy.

We believe the consumer and small business financial services industry is in the early stages of a fundamental shift to online product offerings, similar to the shift that started in retail and travel many years ago and is now well established. We believe that like retail and travel, as consumers continue to move towards online shopping and transactions for financial services, suppliers will increasingly shift their product offerings and advertising budgets toward the online channel. We believe the strength of our brands and of our lender network place us in a strong position to continue to benefit from this market shift.

The LendingTree Loans business is presented as discontinued operations in the accompanying consolidated balance sheets, consolidated statements of operations and comprehensive income and consolidated cash flows for all periods presented. Except for the discussion under the heading "Discontinued Operations," the analysis within Management's Discussion and Analysis of Financial Condition and Results of Operations reflects our continuing operations.

Convertible Senior Notes and Hedge and Warrant Transactions
On May 31, 2017, we issued $300.0 million aggregate principal amount of our 0.625% Convertible Senior Notes due June 1, 2022 and, in connection therewith, entered into Convertible Note Hedge and Warrant transactions with respect to our common stock. For more information, see Note 11—Debt, in the notes to the consolidated financial statements included elsewhere in this report.
Recent Business Acquisitions
On July 23, 2018, we acquired Student Loan Hero, Inc. (“Student Loan Hero”) for $60.7 million cash consideration at the closing of the transaction. Student Loan Hero, a personal finance website dedicated to helping student loan borrowers manage their student debt, offers current and former students in-depth financial comparison tools, educational resources, and unbiased, personalized advice.
On June 11, 2018, we acquired Ovation Credit Services, Inc. (“Ovation”), a leading provider of credit services with a strong customer service reputation for $12.2 million at the closing of the transaction and potential contingent consideration payments of up to $8.75 million through June 2020, subject to achieving specified targets. Ovation utilizes a proprietary software application that facilitates the credit repair process and is integrated directly with certain credit bureaus while educating consumers on credit improvement via ongoing outreach with Ovation case advisors. The proprietary software application offers consumers a simple, streamlined process to identify, dispute, and correct inaccuracies within their credit reports. Ovation's experienced management team, strong credit bureau relationships and customized software platform will enable us to help more consumers achieve their original financial goals through the LendingTree platform.
On September 19, 2017, we acquired certain assets of Snap Capital LLC, which does business under the name SnapCap for $11.9 million in cash at closing and contingent consideration payments of up to $9.0 million through March 31, 2020. SnapCap is a tech-enabled online platform, which connects business owners with lenders offering small business loans, lines of credit and merchant cash advance products through a concierge-based sales approach. We believe that by combining SnapCap's high-touch, high-conversion sales approach with our brand and performance marketing expertise, we can derive substantial revenue synergies and accelerate growth in our small business offering.
On June 20, 2017, we acquired the membership interests of Camino Del Avion (Delaware), LLC, which does business under the name MagnifyMoney for $29.6 million cash consideration at the closing of the transaction. MagnifyMoney is a leading consumer-facing media property that offers editorial content, expert commentary, tools and resources to help consumers compare financial products and make informed financial decisions. The MagnifyMoney team brings the expertise and infrastructure to expand content creation and distribution across all of our consumer facing brands, improving our presence and efficacy in acquisition channels such as search engine optimization.
On June 14, 2017, we acquired substantially all of the assets of Deposits Online, LLC, which does business under the name DepositAccounts.com (“DepositAccounts”) for $24.0 million in cash at closing and contingent consideration payments of up to $9.0 million through June 30, 2020. DepositAccounts is a leading consumer-facing media property in the depository industry and is one of the most comprehensive sources of depository deals and analysis on the Internet, covering all major deposit product categories through editorial content, programmatic rate tables and user-generated content. This acquisition represents our first offering to address the asset side of the consumer balance sheet.
These acquisitions continue our diversification strategy.
Acquisition of North Carolina Office Properties
In December 2016, we completed the acquisition of two office buildings in Charlotte, North Carolina, for $23.5 million in cash. The buildings were acquired with the intent to use such buildings as our principal executive offices in the future; any unused space in the buildings may continue to be occupied by tenants. We are re-evaluating our plans for these buildings.
With our expansion in North Carolina, we received a grant from the state that provides up to $4.9 million in reimbursements over 12 years for investing in real estate and infrastructure in addition to increasing jobs in North Carolina at specific targeted levels through 2020, and maintaining the jobs thereafter. Additionally, the city of Charlotte and the county of Mecklenburg provided a grant that will be paid over five years and is based on a percentage of new property tax we pay on the development.

Seasonality

Revenue in our lending business is subject to cyclical and seasonal trends. Home sales (and purchase mortgages) typically rise during the spring and summer months and decline during the fall and winter months, while refinancing and home equity activity is principally driven by mortgage interest rates as well as real estate values.

We anticipate revenue in our newer products to be cyclical as well; however, we have limited historical data to predict the nature and magnitude of this cyclicality. Based on industry data, we anticipate as our personal loan product matures we will experience less consumer demand during the fourth and first quarters of each year. We also anticipate less consumer demand for credit cards in the fourth quarter of each year and we anticipate higher consumer demand for deposit accounts in the first quarter of each year. The majority of consumer demand for student loan products occurs in the third quarter coinciding with collegiate enrollment in late summer. Other factors affecting our business include macro factors such as credit availability in the market, interest rates, the strength of the economy and employment.

Recent Mortgage Interest Rate Trends

Interest rate and market risks can be substantial in the mortgage lead generation business. Short-term fluctuations in mortgage interest rates primarily affect consumer demand for mortgage refinancings, while long-term fluctuations in mortgage interest rates, coupled with the U.S. real estate market, affect consumer demand for new mortgages. Consumer demand, in turn, affects lender demand for mortgage leads from third-party sources. Typically, a decline in mortgage interest rates will lead to reduced lender demand, as there are more consumers in the marketplace seeking financing and, accordingly, lenders receive more organic lead volume. Conversely, an increase in mortgage interest rates will typically lead to an increase in lender demand, as there are fewer consumers in the marketplace and, accordingly, the supply of organic mortgage lead volume decreases.

According to Freddie Mac, 30-year mortgage interest rates have increased steadily during 2018 to a monthly average of 4.57% in June 2018. On a quarterly basis, 30-year mortgage interest rates in the second quarter of 2018 averaged 4.54%, as compared to 3.99% in the second quarter of 2017 and 4.27% in the first quarter of 2018.

Typically, as mortgage interest rates rise, there are fewer consumers in the marketplace seeking refinancings and, accordingly, the mix of mortgage origination dollars moves towards purchase mortgages. According to Mortgage Bankers Association ("MBA") data, total purchase origination dollars increased to 74% of total mortgage origination dollars in the second quarter of 2018 from 63% in the first quarter of 2018, while total refinance origination dollars decreased to 26% of total mortgage origination dollars in the second quarter of 2018 from 37% in the first quarter of 2018. In the second quarter of 2018, the volume of total refinance origination dollars decreased 20% from the second quarter of 2017 and 8% from the first quarter of 2018.

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Looking forward, MBA is projecting 30-year mortgage interest rates to increase through the end of the year. According to MBA projections, the mix of mortgage origination dollars will move toward purchase mortgages during 2018 with the refinance share representing approximately 29% for 2018.

The U.S. Real Estate Market

The health of the U.S. real estate market and interest rate levels are the primary drivers of consumer demand for new mortgages. Consumer demand, in turn, affects lender demand for purchase mortgage leads from third-party sources. Typically, a strong real estate market will lead to reduced lender demand for leads, as there are more consumers in the marketplace seeking financing and, accordingly, lenders receive more organic lead volume. Conversely, a weaker real estate market will typically lead to an increase in lender demand, as there are fewer consumers in the marketplace seeking mortgages.

According to the National Association of Realtors ("NAR"), despite strong demand in the real estate market, limited inventory of new and existing homes is contributing to declining sales levels. The NAR expects a slight decrease of 0.4% in existing home sales in 2018 from 2017.

Results of Operations for the Three and Six Months ended June 30, 2018 and 2017

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	$ Change	% Change	2018	2017	$ Change	% Change
	(Dollars in thousands)							
Mortgage products	$66,948	$71,515	$(4,567)	(6)%	$140,410	$134,453	$5,957	4 %
Non-mortgage products	117,153	81,258	35,895	44 %	224,726	150,835	73,891	49 %
Revenue	184,101	152,773	31,328	21 %	365,136	285,288	79,848	28 %
Costs and expenses:								
Cost of revenue (exclusive of depreciation and amortization shown separately below)	6,043	4,164	1,879	45 %	11,739	7,755	3,984	51 %
Selling and marketing expense	123,946	109,141	14,805	14 %	249,990	202,392	47,598	24 %
General and administrative expense	24,759	12,094	12,665	105 %	47,573	23,641	23,932	101 %
Product development	5,967	4,064	1,903	47 %	12,227	7,687	4,540	59 %
Depreciation	1,633	1,808	(175)	(10)%	3,304	3,511	(207)	(6)%
Amortization of intangibles	3,964	2,608	1,356	52 %	7,927	5,217	2,710	52 %
Change in fair value of contingent consideration	(167)	9,393	(9,560)	(102)%	(908)	18,139	(19,047)	(105)%
Severance	3	247	(244)	(99)%	3	404	(401)	(99)%
Litigation settlements and contingencies	(170)	285	(455)	(160)%	(192)	689	(881)	(128)%
Total costs and expenses	165,978	143,804	22,174	15 %	331,663	269,435	62,228	23 %
Operating income	18,123	8,969	9,154	102 %	33,473	15,853	17,620	111 %
Other (expense) income, net:								
Interest expense, net	(2,924)	(1,079)	1,845	171 %	(5,912)	(1,244)	4,668	375 %
Other (expense) income	(71)	13	84	646 %	(37)	13	50	385 %
Income before income taxes	15,128	7,903	7,225	91 %	27,524	14,622	12,902	88 %
Income tax benefit	29,721	104	29,617	28,478 %	53,182	1,183	51,999	4,396 %
Net income from continuing operations	44,849	8,007	36,842	460 %	80,706	15,805	64,901	411 %
Loss from discontinued operations, net of tax	(2,302)	(689)	1,613	234 %	(6,635)	(1,621)	5,014	309 %
Net income and comprehensive income	$42,547	$7,318	$35,229	481 %	$74,071	$14,184	$59,887	422 %

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Revenue

Revenue increased in the second quarter of 2018 compared to the second quarter of 2017 due to an increase in our non-mortgage products of $35.9 million, partially offset by a decrease in our mortgage products of $4.6 million. Revenue increased in the first six months of 2018 compared to the first six months of 2017 due to increases in our non-mortgage products of $73.9 million and in our mortgage products of $6.0 million.

Our non-mortgage products include the following non-mortgage lending products: personal loans, credit cards, home equity loans and lines of credit, reverse mortgage loans, auto loans, small business loans and student loans. Our non-mortgage products also include deposit accounts, home improvement referrals and other credit products such as credit repair and debt settlement. Many of our non-mortgage products are not individually significant to revenue. The increase in revenue from our non-mortgage products in the second quarter and first six months of 2018 from the second quarter and first six months of 2017 is primarily due to increases in our personal loans, home equity and credit cards products.

Revenue from our personal loans product increased $15.7 million to $36.2 million in the second quarter of 2018 from $20.5 million in the second quarter of 2017, or 77%, and increased $24.7 million to $62.2 million in the first six months of 2018 from $37.5 million in the first six months of 2017, or 66%, due to increased revenue earned per consumer. Additionally, the number of consumers completing request forms increased as a result of increased lender demand and corresponding increases in selling and marketing efforts.

Revenue from our credit cards product increased $1.7 million to $38.7 million in the second quarter of 2018 from $37.0 million in the second quarter of 2017, or 5%, due to increases in click traffic sent to issuers. Revenue from our credit card product increased $14.1 million to $84.9 million in the first six months of 2018 from $70.8 million in the first six months of 2017, or 20%, due to increased revenue earned per consumer, as well as increases in click traffic sent to issuers.

For the periods presented, no other non-mortgage product represented more than 10% of revenue, however certain other non-mortgage products experienced notable increases. Revenue from our home equity product increased by $5.6 million in the second quarter of 2018 compared to the second quarter of 2017 and increased by $12.6 million in the first six months of 2018 compared to the first six months of 2017 due to increases in the number of consumers completing request forms as a result of increases in lender coverage and lender demand, and corresponding increases in selling and marketing efforts, partially offset by decreased revenue earned per consumer. We believe the market for our non-mortgage products remains under-penetrated and we believe long-term growth prospects are strong for non-mortgage products.

Revenue from our mortgage products decreased in the second quarter of 2018 compared to the second quarter of 2017 due to a decrease in revenue from our refinance product of $7.3 million, partially offset by an increase in revenue from our purchase product of $2.7 million. Revenue from our refinance product decreased in the second quarter of 2018 compared to the second quarter of 2017 primarily due to a decrease in the number of consumers completing request forms as a result of fewer consumers seeking refinancing in a period of rising interest rates. Revenue from our purchase product increased in the second quarter of 2018 compared to the second quarter of 2017 due to an increase in revenue earned per consumer. Revenue from our mortgage products increased in the first six months of 2018 compared to the first six months of 2017 primarily due to an increase in revenue from our purchase product of $5.6 million. The increase in revenue from our purchase product in the first six months of 2018 compared to the first six months of 2017 is primarily due to an increase in revenue earned per consumer.

Cost of revenue

Cost of revenue consists primarily of costs associated with compensation and other employee-related costs (including stock-based compensation) relating to internally-operated customer call centers, third-party customer call center fees, credit scoring fees, credit card fees, website network hosting and server fees.

Cost of revenue increased in the second quarter of 2018 from the second quarter of 2017, primarily due to an increase of $1.1 million in compensation and benefits as a result of increases in headcount and an increase of $0.6 million in credit scoring fees.

Cost of revenue as a percentage of revenue remained consistent at 3% in both the second quarter of 2018 and the second quarter of 2017.

Cost of revenue increased in the first six months of 2018 from the first six months of 2017, primarily due to an increase of $2.0 million in compensation and benefits as a result of increases in headcount, an increase of $0.9 million in credit scoring fees and an increase of $0.8 million in website network hosting and server fees.

Cost of revenue as a percentage of revenue remained consistent at 3% in both the first six months of 2018 and the first six months of 2017.

Selling and marketing expense

Selling and marketing expense consists primarily of advertising and promotional expenditures and compensation and other employee-related costs (including stock-based compensation) for personnel engaged in sales or marketing functions. Advertising and promotional expenditures primarily include online marketing, as well as television, print and radio spending. Advertising production costs are expensed in the period the related ad is first run.

The increase in selling and marketing expense in the second quarter and first six months of 2018 compared to the second quarter and first six months of 2017 were primarily due to increases in advertising and promotional expense of $11.9 million and $40.9 million, respectively, as discussed below.

Advertising and promotional expense is the largest component of selling and marketing expense, and is comprised of the following:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	$ Change	% Change	2018	2017	$ Change	% Change
	(Dollars in thousands)							
Online	$113,289	$92,791	$20,498	22 %	$224,709	$173,451	$51,258	30 %
Broadcast	195	10,172	(9,977)	(98)%	3,435	17,404	(13,969)	(80)%
Other	2,891	1,497	1,394	93 %	6,259	2,607	3,652	140 %
Total advertising expense	$116,375	$104,460	$11,915	11 %	$234,403	$193,462	$40,941	21 %

Revenue is driven by lender demand for our products, which is matched to corresponding consumer loan requests. We adjust our selling and marketing expenditures dynamically in relation to anticipated revenue opportunities in order to ensure sufficient consumer inquiries to profitably meet lender demand. An increase in a product’s revenue is generally met by a corresponding increase in marketing spend, and conversely a decrease in a product’s revenue is generally met by a corresponding decrease in marketing spend. This relationship exists for both mortgage and non-mortgage products.

We increased our advertising expenditures in the second quarter and first six months of 2018 compared to the second quarter and first six months of 2017 in order to generate additional consumer inquiries to meet the increased demand of lenders on our marketplace.

We will continue to adjust selling and marketing expenditures dynamically in relation to anticipated revenue opportunities.

General and administrative expense

General and administrative expense consists primarily of compensation and other employee-related costs (including stock-based compensation) for personnel engaged in finance, legal, tax, corporate information technology, human resources and executive management functions, as well as facilities and infrastructure costs and fees for professional services.

General and administrative expense increased in the second quarter of 2018 from the second quarter of 2017, and in the first six months of 2018 from the first six months of 2017, primarily due to increases in compensation and benefits of $8.9 million and $18.8 million, respectively, as a result of increases in headcount and long-term equity awards granted to our Chairman and Chief Executive Officer in the third quarter of 2017 and in the first quarter of 2018, which awards have both time and significant performance-based vesting conditions. We also granted long-term equity awards to certain members of our leadership team in the fourth quarter of 2017 and in the first quarter of 2018. General and administrative expense is expected to increase in future periods due to the non-cash compensation expense related to these grants. For additional information regarding the awards granted to our Chairman and Chief Executive Officer, see Note 9—Stock-Based Compensation in the notes to the consolidated financial statements included elsewhere in this report. Non-cash compensation expense is excluded from Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization ("Adjusted EBITDA"), as discussed below. In addition, we incurred a charge of $1.6 million in the second quarter and first six months of 2018 due to the write-off of certain fixed assets.

General and administrative expense as a percentage of revenue increased to 13% in the second quarter and first six months of 2018 compared to 8% in the second quarter and first six months of 2017 due to the items above.

Product development

Product development expense consists primarily of compensation and other employee-related costs (including stock-based compensation) and third-party labor costs that are not capitalized, for employees and consultants engaged in the design, development, testing and enhancement of technology.

Product development expense increased in the second quarter and first six months of 2018 compared to the second quarter and first six months of 2017, as we continued to invest in internal development of new and enhanced features, functionality and business opportunities that we believe will enable us to better and more fully serve consumers and lenders.

Amortization of intangibles

Amortization of intangibles increased in the second quarter and first six months of 2018 compared to the second quarter and first six months of 2017 primarily due to intangible assets associated with our business acquisitions in 2017.

Contingent consideration

During the second quarter of 2018, we recorded a net $0.2 million gain due to adjustments in the estimated fair value of the earnout payments related to the CompareCards, DepositAccounts and SnapCap acquisitions. We recorded a $0.8 million gain due to the decreased probability of achievement of certain defined operating results for SnapCap. This was partially offset by contingent consideration expense of $0.2 million for the CompareCards acquisition due to the passage of time increasing the estimated fair value of the earnout payment for CompareCards, and contingent consideration expense of $0.4 million for the DepositAccounts acquisition due to an increased probability of achievement of certain defined earnout targets. During the first six months of 2018, we recorded a net $0.9 million gain due to adjustments in the estimated fair value of the earnout payments related to the CompareCards, DepositAccounts and SnapCap acquisitions. We recorded a $2.9 million gain due to the decreased probability of achievement of certain defined operating results for SnapCap. This was partially offset by contingent consideration expense of $0.7 million for the CompareCards acquisition due to the passage of time increasing the estimated fair value of the earnout payments for CompareCards, and contingent consideration expense of $1.3 million for the DepositAccounts acquisition due to an increased probability of achievement of certain defined earnout targets.

During the second quarter and first six months of 2017, we recorded $9.4 million and $18.1 million, respectively, of contingent consideration expense due to an adjustment in the estimated fair value of the earnout payments related to the CompareCards acquisition primarily due to increased performance of CompareCards.

Income tax expense

For the second quarter and first six months of 2018, the effective tax rate varied from the federal statutory rate of 21% primarily due to a tax benefit of $33.7 million and $60.9 million, respectively, recognized for excess tax benefits due to employee exercises of stock options and vesting of restricted stock in accordance with ASU 2016-09 and the effect of state taxes.

For the second quarter and first six months of 2017, the effective tax rate varied from the federal statutory rate of 35% primarily due to a tax benefit of $3.8 million and $7.6 million, respectively, recognized for excess tax benefits due to employee exercises of stock options and vesting of restricted stock in accordance with ASU 2016-09.

There have been no changes to our valuation allowance assessment for the second quarter of 2018.

Discontinued operations

Losses from discontinued operations are attributable to losses associated with the LendingTree Loans business, the sale of which was completed on June 6, 2012. Losses from discontinued operations were primarily due to litigation settlements and contingencies and legal fees associated with ongoing legal proceedings.

Adjusted EBITDA

We report Adjusted EBITDA as a supplemental measure to GAAP. This measure is the primary metric by which we evaluate the performance of our businesses, on which our marketing expenditures and internal budgets are based and by which management and many employees are compensated. We believe that investors should have access to the same set of tools that we use in analyzing our results. This non-GAAP measure should be considered in addition to results prepared in accordance with GAAP, but should

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not be considered a substitute for or superior to GAAP results. We provide and encourage investors to examine the reconciling adjustments between the GAAP and non-GAAP measures discussed below.

Definition of Adjusted EBITDA

We report Adjusted EBITDA as net income from continuing operations adjusted to exclude interest, income tax, amortization of intangibles and depreciation, and to further exclude (1) non-cash compensation expense, (2) non-cash impairment charges, (3) gain/loss on disposal of assets, (4) restructuring and severance expenses, (5) litigation settlements and contingencies and legal fees for certain patent litigation, (6) acquisitions and dispositions income or expense (including with respect to changes in fair value of contingent consideration) and (7) one-time items. Adjusted EBITDA has certain limitations in that it does not take into account the impact to our statement of operations of certain expenses, including depreciation, non-cash compensation and acquisition-related accounting. We endeavor to compensate for the limitations of the non-GAAP measures presented by also providing the comparable GAAP measures with equal or greater prominence and descriptions of the reconciling items, including quantifying such items, to derive the non-GAAP measures. These non-GAAP measures may not be comparable to similarly titled measures used by other companies.

One-Time Items

Adjusted EBITDA is adjusted for one-time items, if applicable. Items are considered one-time in nature if they are non-recurring, infrequent or unusual and have not occurred in the past two years or are not expected to recur in the next two years, in accordance with SEC rules. For the periods presented in this report, there are no adjustments for one-time items.

Non-Cash Expenses that are Excluded from Adjusted EBITDA

Non-cash compensation expense consists principally of expense associated with grants of restricted stock, restricted stock units and stock options, some of which awards have performance-based vesting conditions. These expenses are not paid in cash, and we include the related shares in our calculations of fully diluted shares outstanding. Upon settlement of restricted stock units, exercise of certain stock options or vesting of restricted stock awards, the awards may be settled, on a net basis, with us remitting the required tax withholding amount from our current funds.

Amortization of intangibles are non-cash expenses relating primarily to intangible assets acquired through acquisitions. At the time of an acquisition, the intangible assets of the acquired company, such as purchase agreements, technology and customer relationships, are valued and amortized over their estimated lives.

The following table is a reconciliation of net income from continuing operations to Adjusted EBITDA (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income from continuing operations	$44,849	$8,007	$80,706	$15,805
Adjustments to reconcile to Adjusted EBITDA:				
Amortization of intangibles	3,964	2,608	7,927	5,217
Depreciation	1,633	1,808	3,304	3,511
Severance	3	247	3	404
Loss on impairments and disposal of assets	1,797	36	1,889	309
Non-cash compensation	11,178	2,900	22,287	5,130
Change in fair value of contingent consideration	(167)	9,393	(908)	18,139
Acquisition expense	625	488	687	1,037
Litigation settlements and contingencies	(170)	285	(192)	689
Interest expense, net	2,924	1,079	5,912	1,244
Rental depreciation and amortization of intangibles	194	263	396	525
Income tax benefit	(29,721)	(104)	(53,182)	(1,183)
Adjusted EBITDA	$37,109	$27,010	$68,829	$50,827

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Financial Position, Liquidity and Capital Resources

General

As of June 30, 2018, we had $293.3 million of cash and cash equivalents and an immaterial amount of restricted cash and cash equivalents, compared to $368.6 million of cash and cash equivalents and $4.1 million of restricted cash and cash equivalents as of December 31, 2017.

In June 2018, we acquired Ovation for $12.2 million in cash at closing and potential future contingent consideration payments of up to $8.75 million through June 30, 2020, subject to achieving specified targets.

During the first six months of 2018, we purchased an aggregate of 156,731 shares of our common stock pursuant to a stock repurchase program for $46.0 million. Additionally, we paid $1.1 million in the first quarter of 2018 related to common stock repurchased in the fourth quarter of 2017.

In May 2017, we issued $300.0 million of our 0.625% Convertible Senior Notes for net proceeds of $290.7 million. We used approximately $18.1 million of the net proceeds to enter into Convertible Note Hedge and Warrant transactions.

In September 2017, we acquired certain assets of SnapCap for $11.9 million in cash at closing and potential future contingent consideration payments of up to $9.0 million through March 31, 2020, subject to achieving specified targets.

In June 2017, we acquired the membership interests of MagnifyMoney for $29.6 million cash consideration at the closing of the transaction.

In June 2017, we acquired substantially all of the assets of DepositAccounts for $24.0 million in cash at closing and potential future contingent consideration payments of up to $9.0 million through June 30, 2020, subject to achieving specified targets. We made contingent consideration payments of $1.0 million in the third quarter of 2017, $1.0 million in the first quarter of 2018, $1.0 million in the second quarter of 2018, and $1.0 million in July 2018.

In November 2016, we acquired CompareCards for $80.7 million in cash at closing and potential future contingent consideration payments of up to $22.5 million for each of 2017 and 2018, subject to achieving specified targets. We made the initial $22.5 million earnout payment in the first quarter of 2018 and paid the remaining $22.5 million earnout in the second quarter of 2018, of which $21.9 million is included within cash flows from operating activities on the consolidated statement of cash flows for the first six months of 2018.

We expect our cash and cash equivalents and cash flows from operations to be sufficient to fund our operating needs for the next twelve months and beyond. Our amended and restated revolving credit facility described below is an additional potential source of liquidity.

In July 2018, we acquired Student Loan Hero for $60.7 million cash consideration at the closing of the transaction.

Senior Secured Revolving Credit Facility

On November 21, 2017, we entered into an amended and restated $250.0 million five-year senior secured revolving credit facility which matures on November 21, 2022 (the "Revolving Credit Facility"). Borrowings under the Revolving Credit Facility can be used to finance working capital needs, capital expenditures and general corporate purposes, including to finance permitted acquisitions. As of July 26, 2018, we do not have any borrowings under the Revolving Credit Facility.

Cash Flows from Continuing Operations

Our cash flows attributable to continuing operations are as follows:

	Six Months Ended June 30,	
	2018	2017
	(in thousands)	
Net cash provided by operating activities	$15,264	$48,224
Net cash used in investing activities	(18,441)	(57,026)
Net cash (used in) provided by financing activities	(71,890)	274,612

Cash Flows from Operating Activities

Our largest source of cash provided by our operating activities is revenues generated by our mortgage and non-mortgage products. Our primary uses of cash from our operating activities include advertising and promotional payments. In addition, our uses of cash from operating activities include compensation and other employee-related costs, other general corporate expenditures, litigation settlements and contingencies and income taxes.

Net cash provided by operating activities attributable to continuing operations decreased in the first six months of 2018 from the first six months of 2017 primarily due to the $21.9 million portion of the CompareCards earnout payment made in the second quarter of 2018 in excess of the contingent consideration liability recognized at the acquisition date. Further, the increase in revenue in the first six months of 2018 from the first six months of 2017 was offset by an increase in selling and marketing expense and a net decrease in cash from changes in working capital primarily driven by changes in accounts receivable and accounts payable, accrued expenses and other current liabilities.

Cash Flows from Investing Activities

Net cash used in investing activities attributable to continuing operations in the first six months of 2018 of $18.4 million consisted primarily of the acquisition of Ovation for $11.7 million, net of cash acquired, and capital expenditures of $6.7 million related to internally developed software.

Net cash used in investing activities attributable to continuing operations in the first six months of 2017 of $57.0 million consisted primarily of the acquisition of MagnifyMoney for $29.4 million, net of cash acquired, the acquisition of DepositAccounts for $24.0 million and capital expenditures of $3.6 million related to internally developed software.

Cash Flows from Financing Activities

Net cash used in financing activities attributable to continuing operations in the first six months of 2018 of $71.9 million consisted primarily of $25.6 million of contingent consideration payments for CompareCards, DepositAccounts and SimpleTuition and $47.1 million for the repurchase of our stock.

Net cash provided by financing activities attributable to continuing operations in the first six months of 2017 of $274.6 million consisted primarily of $300.0 million of gross proceeds from the issuance of convertible senior notes and $43.4 million of proceeds from the sale of warrants in connection with the convertible senior notes, partially offset by $61.5 million for the payment of convertible note hedge transactions and $8.6 million for the payment of convertible senior note issuance costs.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements other than our operating lease obligations and funding commitments pursuant to our surety bonds, none of which have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

New Accounting Pronouncements

For information regarding new accounting pronouncements, see Note 2—Significant Accounting Policies, in Part I, Item 1 Financial Statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Other than our Revolving Credit Facility, we do not have any financial instruments that are exposed to significant market risk. We maintain our cash and cash equivalents in bank deposits and short-term, highly liquid money market investments. A hypothetical 100-basis point increase or decrease in market interest rates would not have a material impact on the fair value of our cash equivalents securities, or our earnings on such cash equivalents, but would have an effect on the interest paid on borrowings under the Revolving Credit Facility, if any. As of July 26, 2018, there were no borrowings under the Revolving Credit Facility. Increases in the Federal Funds interest rates may also affect contingent consideration payable to DepositAccounts. See Note 6—Business Acquisition—Changes in Contingent Consideration—DepositAccounts.

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Fluctuations in interest rates affect consumer demand for new mortgages and the level of refinancing activity which, in turn, affects lender demand for mortgage leads. Typically, a decline in mortgage interest rates will lead to reduced lender demand for leads from third-party sources, as there are more consumers in the marketplace seeking refinancings and, accordingly, lenders receive more organic lead volume. Conversely, an increase in mortgage interest rates will typically lead to an increase in lender demand for third-party leads, as there are fewer consumers in the marketplace and, accordingly, the supply of organic mortgage lead volume decreases. See also the risk factor "Adverse conditions in the primary and secondary mortgage markets, as well as the general economy, could materially and adversely affect our business, financial condition and results of operations," in Part I, Item 1A (Risk Factors) in our 2017 Annual Report.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), management, with the participation of our principal executive officer (our Chief Executive Officer) and principal financial officer (our Chief Financial Officer), evaluated, as of the end of the period covered by this report, the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective, as of June 30, 2018, to reasonably ensure that information required to be disclosed and filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified, and that management will be timely alerted to material information required to be included in our periodic reports filed with the Securities and Exchange Commission.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended June 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of business, we are party to litigation involving property, contract, intellectual property and a variety of other claims. The amounts that may be recovered in such matters may be subject to insurance coverage. We have provided information about certain legal proceedings in which we are involved in Part I, Item 3. Legal Proceedings of our 2017 Annual Report and updated that information in Note 12—Contingencies to the consolidated financial statements included elsewhere in this report.

Item 1A. Risk Factors

There have been no material changes to the risk factors included in Part I, Item 1A. Risk Factors of our 2017 Annual Report.

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

Issuer Purchases of Equity Securities

In each of January 2010, May 2014, January 2016, February 2016 and February 2018, the board of directors authorized and we announced a stock repurchase program which allowed for the repurchase of up to $10.0 million, $10.0 million, $50.0 million, $40.0 million and $100.0 million, respectively, of our common stock. Under this program, we can repurchase stock in the open market or through privately-negotiated transactions. We have used available cash to finance these repurchases. We will determine the timing and amount of any additional repurchases based on our evaluation of market conditions, applicable SEC guidelines and regulations, and other factors. This program may be suspended or discontinued at any time at the discretion of our board of directors. During the quarter ended June 30, 2018, 126,315 shares of common stock were repurchased under the stock repurchase program. As of July 20, 2018, approximately $81.7 million remains authorized for share repurchase.

Additionally, the LendingTree Fifth Amended and Restated 2008 Stock and Award Incentive Plan and the LendingTree 2017 Inducement Grant Plan allow employees to forfeit shares of our common stock to satisfy federal and state withholding obligations upon the exercise of stock options, the settlement of restricted stock unit awards and the vesting of restricted stock awards granted to those individuals under the plans. During the quarter ended June 30, 2018, 21,288 shares were purchased related to these obligations under the LendingTree Fifth Amended and Restated 2008 Stock and Award Incentive Plan and no shares have yet been purchased related to these obligations under the LendingTree 2017 Inducement Grant Plan. The withholding of those shares does not affect the dollar amount or number of shares that may be purchased under the stock repurchase program described above.

The following table provides information about the company's purchases of equity securities during the quarter ended June 30, 2018.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs (in thousands)
4/1/18 - 4/30/18	68,492	$ 292.37	52,756	$ 101,747
5/1/18 - 5/31/18	75,023	$ 271.93	73,559	$ 81,745
6/1/18 - 6/30/18	4,088	$ 256.84	—	$ 81,745
Total	147,603	$ 281.00	126,315	$ 81,745

(1) During April 2018, May 2018 and June 2018, 15,736 shares, 1,464 shares and 4,088 shares, respectively (totaling 21,288 shares), were purchased to satisfy federal and state withholding obligations of our employees upon the settlement of restricted stock units and restricted stock awards, all in accordance with our Fifth Amended and Restated 2008 Stock and Award Incentive Plan, as described above.

(2) See the narrative disclosure above the table for further description of our publicly announced stock repurchase program.

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Item 5. Other Information

None.

Item 6. Exhibits

Exhibit	Description	Location
3.1	Amended and Restated Certificate of Incorporation of LendingTree, Inc.	Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed August 25, 2008
3.2	Fourth Amended and Restated By-laws of LendingTree, Inc.	Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed November 15, 2017
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	†
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	†
32.1	Certification of the 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 the Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	††
101.INS	XBRL Instance Document	†††
101.SCH	XBRL Taxonomy Extension Schema Document	†††
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	†††
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	†††
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	†††
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	†††

† Filed herewith
†† This certification is being furnished solely to accompany this report pursuant to 18 U.S.C. 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934 and is not to be incorporated by reference into any filing of the registrant, whether made before or after the date hereof, regardless of any general incorporation language in such filing.
††† Furnished herewith. Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURE

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

Date: July 26, 2018

LENDINGTREE, INC.

By: /s/ J.D. MORIARTY
J.D. Moriarty
Chief Financial Officer
(principal financial officer and duly authorized officer)

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