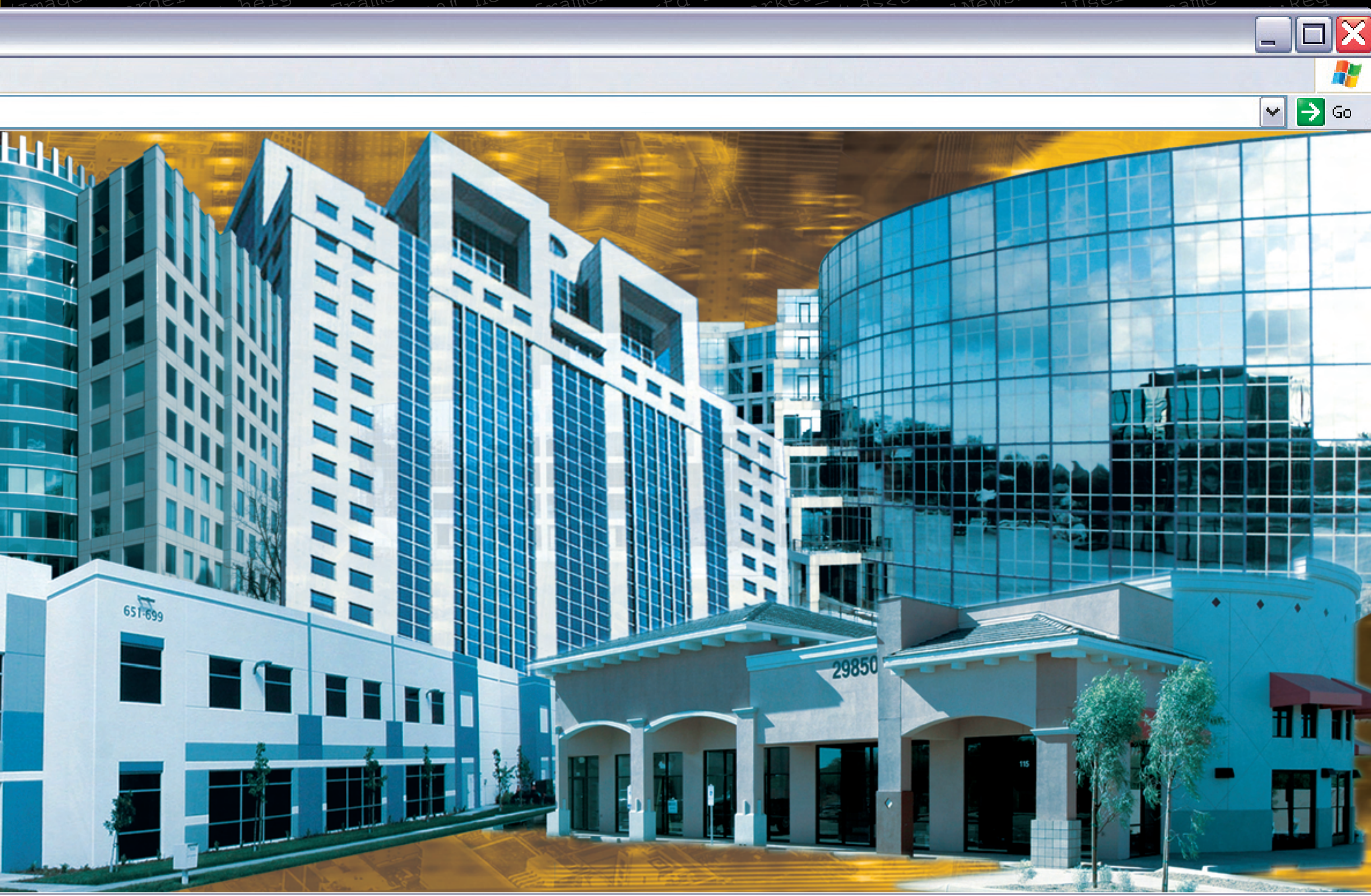
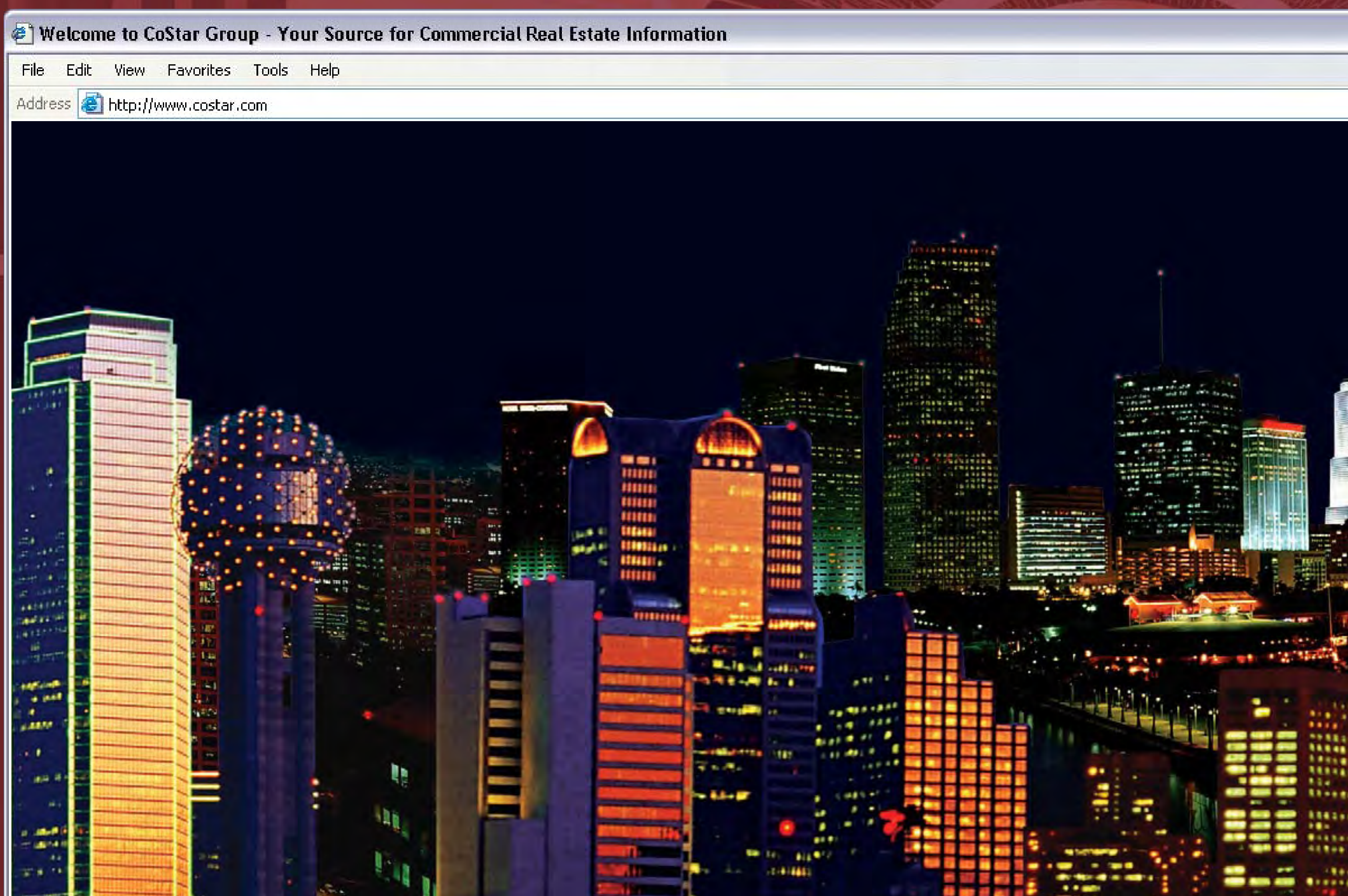
2003 Annual Report

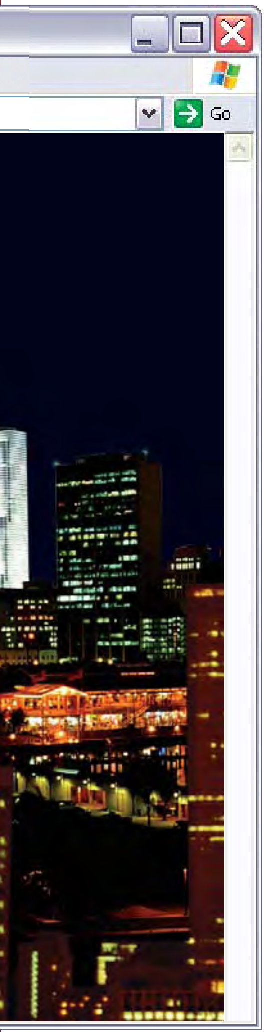


CoStar Group®

Real Estate Information

INFORMATION. INSIGHT. PERSPECTIVE.





In the busy, fast-paced arena of commercial real estate, CoStar's leadership role as information provider continues to grow. We serve at the hub of dynamic activity. Around us, corporate tenants are leasing office space. Investors are buying and selling apartment complexes and industrial parks. Lenders are underwriting shopping center mortgages. All of these transactions, and countless others, concern and involve a virtual army of participants — everyone from property owners, brokers, lenders and investors to appraisers, attorneys and consultants.

For all of these professionals, information is their lifeblood. And, in the United States and United Kingdom, CoStar is their principal source of information.

CoStar empowers its customers with the information, insight and perspective to efficiently perform their leasing, sales and valuation processes. Our powerful Web-based technology enables commercial real estate professionals to access comprehensive property data, perform sophisticated analyses and provide their clients with professional-quality presentations and reports. Our services reduce activities that once took days to a matter of hours and minutes.

Whether it's CoStar Property® to find space for lease and position properties in the marketplace, CoStar COMPS® to precisely value an asset, CoStar Tenant® to identify leasing prospects, or FOCUS to collect London lease comps, CoStar is prominent in almost every major commercial real estate firm in the United States and United Kingdom.

With such widespread involvement as prologue, CoStar looks forward to a coming year of new growth — a year in which we expect to expand our service offerings, introduce CoStar services in new geographic markets and pursue new technologies.

FINANCIAL HIGHLIGHTS

Welcome to CoStar Group - Your Source for Commercial Real Estate Information

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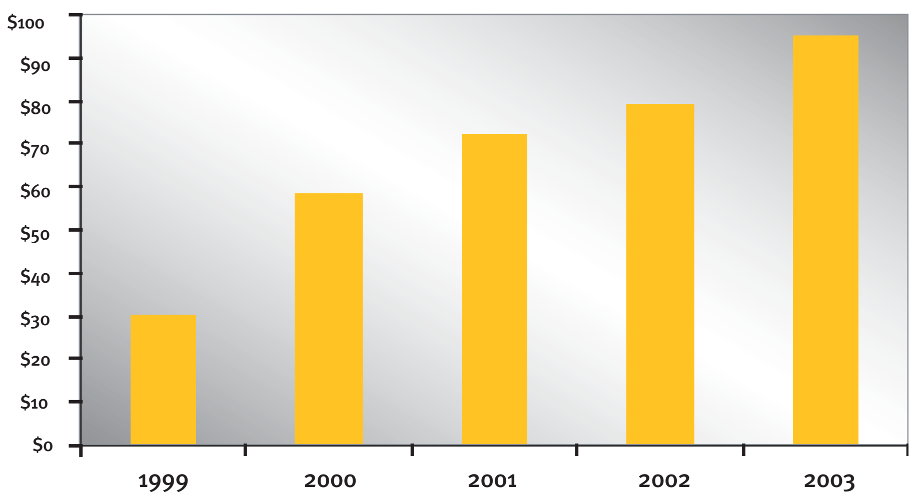
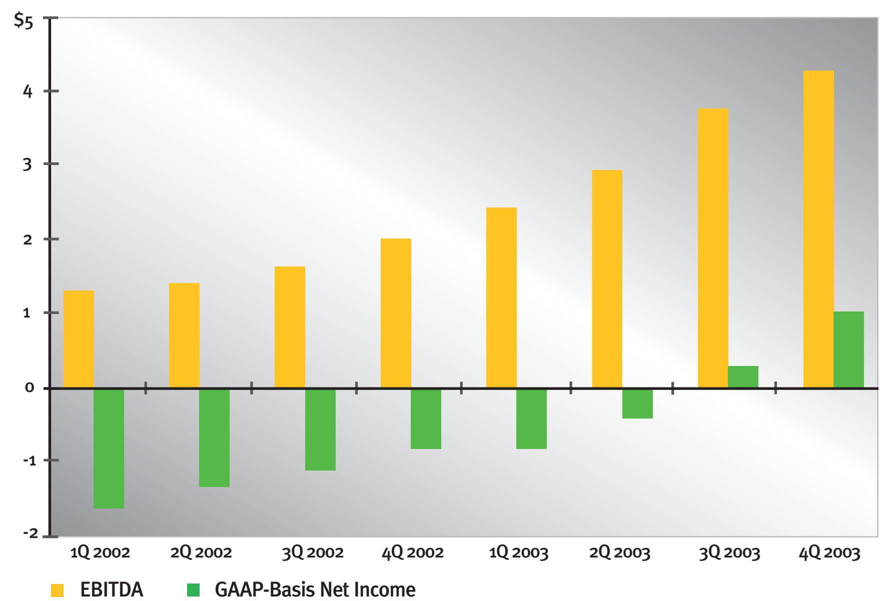
In thousands, except per share data	2001	2002	2003
Revenues	$ 72,513	$ 79,363	$ 95,105
Net income (loss)	$ (20,161)	$ (4,784)	$ 100
Net income (loss) per share-diluted	$ (1.29)	$ (0.30)	$ 0.01
Weighted average outstanding shares-diluted	15,636	15,759	16,674
Cash, cash equivalents, cash held for acquisition and short-term investments	$ 42,002	$ 43,530	$ 97,449
Total assets	$ 123,646	$ 118,907	$ 183,900
Stockholders' equity	$ 108,019	$ 104,017	$ 168,369

Five Year Revenue Growth
($'s in millions)

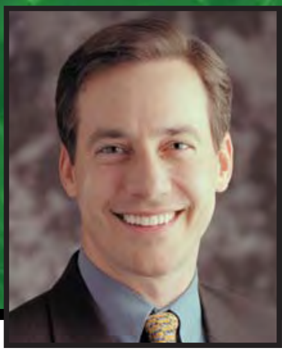


Comparison of Quarterly EBITDA and GAAP-Basis Net Income (Loss)
($'s in millions)



EBITDA is GAAP-basis net income (loss) before interest, taxes, depreciation and amortization.

See page 12A for reconciliation of Quarterly EBITDA with 2002-2003 Quarterly Net Income (Loss)



TO OUR SHAREHOLDERS

I am pleased to report that 2003 was an outstanding year for CoStar Group, Inc. — a year in which we achieved a number of near-term goals while positioning the Company for significant growth in 2004 and beyond.

In 2003, our revenues broke through the $100 million mark on an annualized basis, and our organic quarter-to-quarter revenue growth increased during the year to the highest levels in 12 quarters. We reported our first year of GAAP-basis profit and positioned the Company for accelerated growth with a successful follow-on public offering.

2003 was a breakthrough year for our services. We completed the highly successful deployment of our new Web-based technology platform and retired all prior desktop versions of our services. Acceptance of the new CoStar Property Professional™ system has exceeded our highest hopes for smooth adoption, and overall usage of our subscription-based services has increased dramatically. Further, the investment we made in customer service in 2002 and 2003 paid off with the highest customer retention level in years.

We are filled with enthusiasm as we face a new year and look back on our recent accomplishments.

2003 ACCOMPLISHMENTS

Looking at our performance for 2003, the Company had revenues of $95.1 million, an increase of 19.8% over the previous year. The tremendous leverage in our business model was particularly evident in the dramatic earnings growth the Company achieved in 2003. Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) more than doubled to $13.2 million in 2003. On a GAAP-basis, our performance improved from a GAAP-basis net loss of $(4.8) million or $(0.30) per share in 2002 to GAAP-basis net income of $100,000 or $0.01 per share in 2003.

In addition, we saw an acceleration of our quarterly sequential revenue growth rates throughout 2003. The quarter-to-quarter revenue growth rates in the second half of 2003 were substantially higher than the quarter-to-quarter revenue growth rates we experienced in 2002, and represented the highest organic quarterly sequential revenue growth we have seen since the first quarter of 2000.

We ended the year with $97.4 million in cash, cash equivalents and short-term investments, and no long-term debt. Our cash position is significant due in large part to the Company's follow-on public offering, which closed in November 2003 and resulted in net proceeds of $53.5 million. We continue to enjoy an excellent balance sheet and are in an outstanding financial position as we move forward to pursue a wide range of growth opportunities.

Our strong performance in 2003 is largely the result of three primary factors: the success of our new technology platform, our exhaustive effort to improve customer service and improving market conditions.

The success of our new platform contributed significantly to our strong performance in 2003. We scored a huge technology win with the new CoStar Property Professional system. Customers really seem to enjoy using this new service. It's easier to learn, easier to use and provides a clear technology advantage over anything else in the market, including prior versions of our software.

Following the initial launch of our Web-based platform in December 2002,

we released about a dozen major upgrades to the CoStar Property Professional system during 2003, including enhanced statistics and analytics, a relationship-based professional directory, integrated satellite aerial images and quarterly market reports covering industrial properties.

The analytics and forecasting tools are the most powerful of their kind. Customers can analyze their properties and portfolios, benchmark their performance against peer groups and forecast future market conditions. Our large multi-market customers, in particular, derive significant benefit from these new analytic features, which enable them to evaluate properties and portfolios on a national level. No other service comes close to offering such a robust and flexible tool for analysis and forecasting.

One of our fastest-growing client segments is national consumers of data — institutional investment managers, life insurance companies, commercial banks, and the Wall Street investment banks that underwrite commercial real estate equities and mortgages. We now have a strong offering for these customers, who are more interested in analytics than availabilities and whose investment traditionally is not bound by geography.

DELIVERING VALUE TO OUR CUSTOMERS

All of these features, and more, enable our customers to derive greater value from CoStar services. We saw that value reflected in customer usage levels that grew at an amazing rate in 2003. The number of average weekly page views in CoStar Property Professional, our primary metric for measuring usage, increased 46% from the third quarter of 2003 to the fourth quarter of 2003 and is now approaching 5 million. Usage of CoStar COMPS®, our second-largest revenue generator, currently is running approximately 25% higher than the very consistent levels we experienced throughout 2003. Simply put, we believe more customers are using our services than ever before, and they're using them more often.

On November 30, 2003, we successfully discontinued all of our remaining desktop applications. This represents substantial cost savings and enables our software development, customer service and support teams to focus all of their energy on CoStar's suite of Web-based services.

Throughout the year, our entire organization was focused on providing outstanding customer service toward achieving this goal. Our account executives conducted over 11,000 trainings in 2003, the vast majority of them being one-on-one sessions at the customer's desk. In addition, our customer service staff answered over 91,000 calls with an average wait time of 41 seconds—close to the 30-second standard of most emergency 911 systems. This intensive investment in customer service contributed greatly to the successful adoption of the new system.

The ultimate indicator of customer satisfaction is our renewal rate, which climbed steadily throughout the year. The 91% renewal rate we experienced in the fourth quarter of 2003 is close to the highest level we have ever seen.

As part of our regular marketing research, we conducted focus groups in eight cities in the summer and fall of 2003 to further assess our products and competitive position. Approximately 140 commercial real estate professionals were interviewed about their opinions and

perceptions on commercial real estate information services. The results confirmed our belief that our competitive position is exceptionally strong. In fact, nine out of 10 people surveyed cited CoStar as their "go to" source, the first place they would turn for commercial real estate information. Many described features that are only available in CoStar services as features they cannot live without. Much of the intelligence we garnered is already reflected in our product development, customer service and marketing initiatives.

IMPROVING MARKET CONDITIONS

After three years of steep declines, the commercial real estate market stabilized in 2003 and began to show clear signs of improvement. The national vacancy rate for office space held steady at 14.8% in both the third and fourth quarters of 2003 after increasing for 10 consecutive quarters. Net absorption of office space also returned to positive territory for the first time since 2000. While the 22 million square feet of net absorption in 2003 is about one-third of the absorption we would see in a normal year, it's a long way from the 100 million square feet of negative net absorption during the previous 10 quarters. While the Company has proven its ability to grow in the most severe market conditions, improving market conditions clearly provide a more favorable selling environment.

NEW SERVICES

We achieved another significant service development breakthrough in November 2003 with the launch of CoStar Property Express™. Property Express gives customers convenient access — via a subscription or on-demand with a credit card — to CoStar's comprehensive national for-lease and for-sale listings. We believe this "light" version of CoStar Property will be particularly valued among smaller brokerage firms and property owners where we traditionally have had our lowest penetration rates. These prospects are particularly price sensitive and may be reluctant to commit to an annual subscription for their entire firm. We believe that once these customers experience the value of our services through Property Express, many of them will want to upgrade to the full-featured Professional system. Now CoStar can offer prospective customers the choice of first-class or coach, depending on what they wish to accomplish and how much they wish to pay.

EXTENDING OUR REACH

In January 2003, we achieved our longstanding goal of international expansion with the acquisition of London-based Property Intelligence plc, which operates under the FOCUS brand. The U.K. operation performed in line with our expectations in 2003 and promises to be a strong platform for future growth. Approximately two-thirds of CoStar's 20 largest U.S. customers have operations or affiliates in the U.K. So now, our largest customers in the United States are also our largest customers in the U.K.

In September 2003, we completed our first international sale — a license agreement to provide property data on New York, Los Angeles, Boston and London to professionals at investment bank Bear, Stearns & Co. in New York and London. The deal was negotiated on both sides of the Atlantic by our London and New York teams. We believe there are many more large opportunities like this and potentially thousands of

smaller ones that will be enabled and facilitated by a single, common international information platform.

In 2004, we intend to focus on geographic expansion to lay the foundation for future revenue and earnings growth. We expect to enter 21 new U.S. markets in 2004 and 2005, marking our first major expansion in four years. For many of the markets we are already in, we plan to extend the geographic boundaries by expanding the list of counties we proactively cover.

We believe we can enter these markets with unprecedented financial efficiency, delivering the highest quality databases yet. In total, we expect these markets will add more than 4 billion square feet and hundreds of thousands of valuable properties to our active database inventory. We are very excited about what the addition of these new markets will do for our clients and our business, and we believe this expansion strategy offers a balance between growing earnings and investing in new markets.

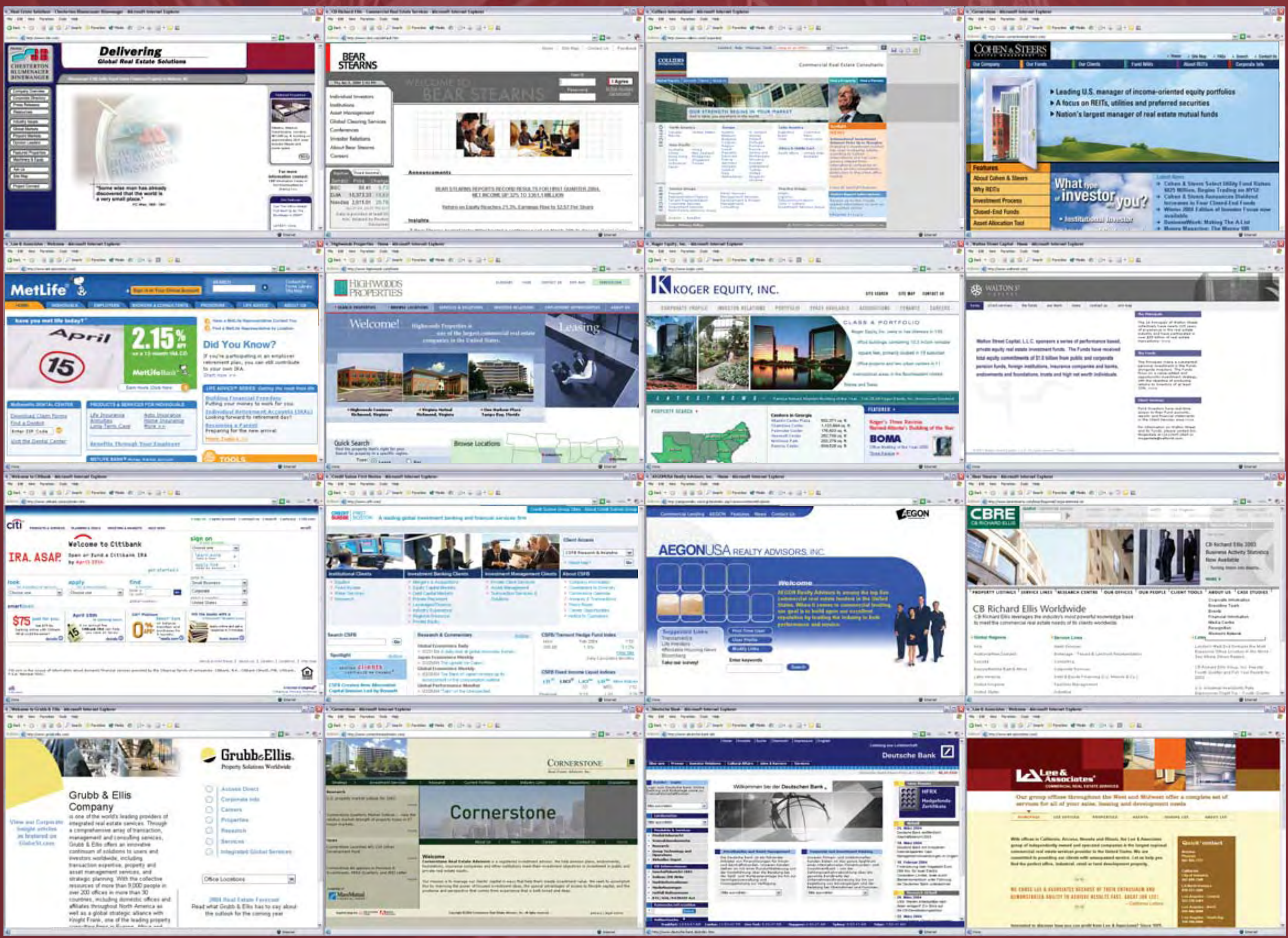
In addition to our planned geographic expansion and expected deeper sales penetration of our existing markets, we are highly focused on multiple drivers of growth in 2004. These include development of new services, cross-selling to current customers and acquisition opportunities. I look forward to updating you on our progress.

Andrew C. Florance
President and Chief Executive Officer
CoStar Group, Inc.

MULTIPLE DRIVERS OF GROWTH

- Development of new services
- Sales penetration into existing markets with existing services
- Cross selling services to existing clients
- Broad geographical expansion
- Pricing leverage
- Acquisition opportunities

MAJOR SIGNINGS



During 2003, CoStar Group signed new contracts and renewal agreements with many of the industry's leading commercial real estate firms, including those listed below.

Of particular note, in July 2003, two of our largest clients became one company when CB Richard Ellis acquired Insignia/ESG, Inc. Now the world's largest real estate services firm, CB Richard Ellis signed a long-term renewal with CoStar, which combined and expanded the separate agreements previously held with CoStar by the two companies.

In addition, Grubb & Ellis Company signed a multi-year contract extension for multiple CoStar services and Coldwell Banker Commercial NRT — the largest single Coldwell Banker franchisee — signed a multi-year agreement to provide a variety of subscription services for many of their offices across the country.

COMMERCIAL REAL ESTATE SERVICES

- Binswanger/CBB
- CB Richard Ellis
- Coldwell Banker NRT
- Colliers McCauley-Nichols
- Grubb & Ellis Company
- Holliday Fenoglio Fowler, LP
- Lee & Associates
- Meredith & Grew, Inc.
- NAI Capital Commercial
- RE/MAX of California and Hawaii

PROPERTY OWNERS

- Childress Klein Properties
- Forest City Enterprises
- Highwoods Properties
- Koger Equity, Inc.
- Taylor & Mathis, Inc.
- Walton Street Capital, LLC

LENDERS/FINANCIAL SERVICES

- Bear, Stearns & Co. Inc.
- Citibank
- Commerce Bancorp, Inc.
- Credit Suisse First Boston, LLC
- Friedman, Billings, Ramsey Group, Inc.

INSTITUTIONAL INVESTORS

- AEGON USA Realty Advisors, Inc.
- Chilton Investment Co.
- Cohen & Steers Capital Management, Inc.
- Cornerstone Real Estate Advisors, Inc.
- Deutsche Bank AG
- Metropolitan Life Insurance Co.
- Ramius Capital Group, LLC

OUR SERVICES

COSTAR PROPERTY PROFESSIONAL™

CoStar Property Professional delivers a comprehensive inventory of office and industrial properties in 50 U.S. markets. Commercial real estate professionals use CoStar Property to identify available space, evaluate leasing and sale opportunities, value assets and position properties in the marketplace. Customers also use CoStar Property Professional to analyze market conditions and forecast future trends by calculating current vacancy rates, absorption rates or average rental rates. When used together with CoStar Connect®, it enables subscribers to share CoStar content and deal-related documents with their clients through their corporate Web site. Subscribers use the integrated CoStar Professional Directory™ to network with industry peers, perform due diligence on potential partners and create targeted mailing lists for marketing.

COSTAR PROPERTY EXPRESS™

A "light" version of CoStar Property Professional, CoStar Property Express provides on-demand access via credit card to CoStar's comprehensive national listings database. Anyone with a need for quality commercial real estate information can use CoStar Property Express to search or lookup for-lease and for-sale listings, view photos, floor plans and maps, and print professional reports. CoStar Property Express is also available on a subscription basis.

COSTAR COMPS PROFESSIONAL™

CoStar COMPS Professional provides comprehensive, national coverage of comparable sales information in the U.S. commercial real estate industry. It is the industry's most complete database of comparable sales transactions designed for professionals who need to research property comparables, identify market trends, expedite the appraisal process and support property valuations.

COSTAR COMPS EXPRESS™

CoStar COMPS Express provides users with immediate, subscription-free access to the industry leading CoStar COMPS Professional system on a report-by-report basis. COMPS Express meets the needs of valuation professionals who have an occasional need to research property comparables. COMPS Professional subscribers use this convenient on-demand service to research property comps outside of their subscription markets.

COSTAR EXCHANGE®

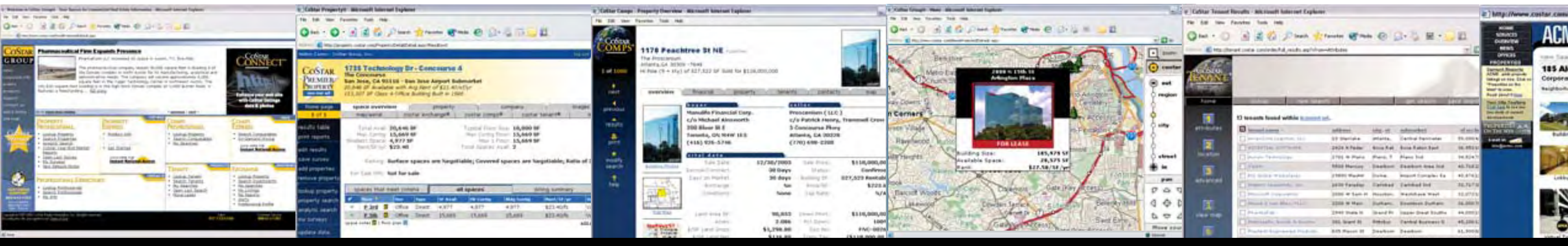
CoStar Exchange is an online marketplace for buying and selling U.S. commercial properties. The industry's premier service, this easily accessible database includes correlating data on space availability, tenants, comparable sales and digital images. Customers use this service to post and search for properties quickly and efficiently. Our broker-centric model provides an efficient means for sellers to reach a large pre-qualified audience and for buyers to more effectively identify target properties.

COSTAR CONNECT®

CoStar Connect enables commercial real estate firms to license CoStar technology and content to market their property listings on their corporate Web sites. Customers enhance the quality and depth of their listing information through access to CoStar's database of content and digital images. The service automatically updates and manages online property information, providing comprehensive listings coverage and significantly reducing the expense of building Web site content and functionality.

COSTAR TENANT®

CoStar Tenant is a detailed online business-to-business prospecting and analytical tool providing commercial real estate professionals with the most comprehensive tenant information available. CoStar Tenant profiles tenants occupying space in commercial buildings across the United States and provides updates on lease expirations — one of the product's key features — as well as occupancy levels, growth rates and numerous other facts. Powerful search capabilities enable users to target prospective clients quickly. CoStar Tenant subscribers can also obtain credit reports through CoStar Tenant directly from D&B®.



COSTAR MARKET REPORTS

The CoStar Office and Industrial Reports provide in-depth current and historical data covering approximately 40 of the major metropolitan markets in the United States. Published quarterly, each market report includes details such as absorption, vacancy, and rental rates; average sales prices, capitalization rates, existing inventory and current construction activity. Information in the CoStar reports is presented using standard definitions and calculations developed by CoStar, and offers real estate professionals the critical and unbiased information necessary to make intelligent commercial real estate decisions.

COSTAR NEWS

Our Web site, services and e-mail news dispatches have become an accepted source of reliable industry news. In 2003, we published over 7,500 news stories. Our NewsWire feature keeps clients informed of late-breaking commercial real estate news, including lease deals signed, recent acquisitions and people on the move.

COSTAR ARES® 6.0

CoStar ARES is a leading contact management and business development tool for commercial real estate professionals. It is a commercial real estate specific add-on to ACT! 6.0, a leading contact management software program. As a value-added application, ARES is used as a customizable office-wide repository for contacts, property listings and comparables and provides importing of data from other CoStar subscription products.

COSTAR ADVERTISING™

CoStar Advertising offers property owners and listing agents a highly targeted and cost effective way to market available space directly to the brokers looking for that type of space. With the CoStar Advertising program, when the advertiser's listing appears in a results set, they receive priority positioning and are enhanced to stand out. The advertiser can also purchase exposure in a broader market area so that the property receives exposure even when the listing does not appear in a results set.

FOCUS

Our U.K. subsidiary, Property Intelligence Limited, offers several services under the trade name FOCUS. The primary product, FOCUS, is a digital online service offering information on the U.K. commercial real estate market. The product seamlessly links data on individual properties and companies including comparable sales, available space, requirements, tenants, lease deals, planning information, socioeconomics and demographics, credit ratings, photos and maps across the United Kingdom.

METROPOLIS

The Metropolis software system combines commercial real estate data from multiple information providers into a comprehensive single interface. Metropolis enables a user to input a property address and then view detailed information on that property from CoStar products as well as a variety of other information sources. This technology offers commercial real estate professionals a simple and convenient solution for integrating a wealth of third-party information and proprietary data, and is currently available for the Southern California markets.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2003

Commission file number 0-24531

CoStar Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**52-2091509**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2 Bethesda Metro Center, 10th Floor
Bethesda, Maryland 20814
(Address of principal executive offices) (zip code)

(301) 215-8300
Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:
None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock ($.01 par value)

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 of the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any statement to this Form 10-K. [X]

Based on the closing price of the common stock on June 30, 2003 on the Nasdaq Stock Market®, the aggregate market value of registrant's common stock held by non-affiliates of the registrant was approximately $418.5 million.

As of March 1, 2004, there were 18,052,769 shares of registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement, which is expected to be filed with the Securities and Exchange Commission within 120 days after the end of the registrant's fiscal year ended December 31, 2003, are incorporated by reference into Part III of this Report.

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PART I

Item 1. Business

(In this report, the words "we," "our," "us," "CoStar" or the "Company" refer to CoStar Group, Inc. and its direct and indirect subsidiaries. This report also refers to our web sites, but information contained on those sites is not part of this report.)

CoStar Group, Inc., a Delaware corporation, is the leading provider of information services to the commercial real estate industry in the United States and United Kingdom based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department and the most clients in the industry, provide more information services than any of our competitors and believe we generate more revenues than any of our competitors. CoStar's integrated suite of services offers customers online access to the most comprehensive database of commercial real estate information, which has been researched and verified by our team of researchers, currently covering 50 U.S. markets as well as London and the United Kingdom.

Since its founding in 1987, CoStar's strategy has been to provide commercial real estate professionals with critical knowledge to complete transactions, by offering the most comprehensive, timely and standardized information on commercial real estate. As a result of our January 2003 acquisition of Property Intelligence Limited, we have extended our offering of comprehensive commercial real estate information to include London and other U.K. markets. We deliver our content to customers via an integrated suite of online service offerings that includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, information for clients' web sites, information about industry professionals and their business relationships, analytic information, data integration, property marketing, organizational tools for contact and property information and industry news. We have created a standardized information platform where the commercial real estate industry and related businesses can continuously interact and easily facilitate transactions due to efficient exchange of accurate information supplied by CoStar. In 2003, we completed the transition of our subscription-based information services from desktop applications to the fully Web-based technology platform initially released in December 2002.

We have a number of assets that provide a unique foundation for this multinational platform, including the most comprehensive, proprietary database in the industry; the largest research department in the industry; advanced software and proprietary technology, including a large in-house product development team; a broad suite of web-based information services; and what we believe is the largest number of clients. Our database has been developed and enhanced for more than 16 years by a research department that makes thousands of daily updates to our database. In addition to our internal efforts to grow the database, we have obtained and assimilated over 50 proprietary databases.

Our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate over 90% of our total revenues. Our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may increase in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis.

Industry Overview

The market for commercial real estate information is vast based on the variety, volume and value of transactions related to commercial real estate. Each transaction has multiple participants and multiple information requirements, and in order to facilitate transactions, industry participants must have extensive, accurate and current information. Members of the commercial real estate and related business community require daily access to current data such as space availability, rental rates, vacancy rates, tenant movements, sales comparables, supply, new construction, absorption rates and other important market developments to carry out their businesses effectively. There is a strong need for an efficient marketplace, where commercial real estate professionals can exchange information, evaluate opportunities using standardized data and interact with each other on a continuous basis.

A large number of parties involved in the commercial real estate and related business community make use of the services we provide in order to obtain information they need to conduct their businesses, including:

- Sales and leasing brokers
- Property owners
- Property managers
- Design and construction professionals
- Real estate developers
- Real estate investment trust managers
- Investment bankers
- Commercial bankers
- Mortgage bankers
- Mortgage brokers
- Government agencies' staff members
- Mortgage-backed security issuers
- Appraisers
- Pension fund managers
- Reporters
- Tenant vendors
- Building services vendors
- Communications providers
- Insurance companies' managers
- Institutional advisors
- Investors and asset managers

The commercial real estate and related business community generally operates in an inefficient marketplace because of the fragmented approach to gathering and exchanging information within the marketplace. Various organizations, including hundreds of brokerage firms, directory publishers and local research companies, collect data on specific markets and develop software to analyze the information they have independently gathered. This highly fragmented methodology has resulted in duplication of effort in the collection and analysis of information, excessive internal cost and the creation of non-standardized data containing varying degrees of accuracy and comprehensiveness, resulting in a formidable information gap.

The creation of a standardized information platform for commercial real estate requires an infrastructure including a standardized database, accurate and comprehensive research capabilities, easy to use technology and intensive participant interaction. By combining its extensive database, over 550 experienced researchers, technological expertise and broad customer base, CoStar believes that it has created such a platform.

CoStar's Comprehensive Database

CoStar has spent more than 16 years building and acquiring a database of commercial real estate information, which includes information on leasing, sales, comparable sales, tenants, demand statistics and digital images.

As of December 31, 2003, our database of real estate information covered 50 U.S. markets as well as London, England and other parts of the United Kingdom, and contained:

- More than 27.7 billion square feet of U.S. commercial real estate;
- Over 1.5 million properties;
- Over 4.0 billion square feet of space available;
- Over 57,000 properties for sale;
- Over 2.9 million tenants occupying commercial real estate space;
- More than 1.1 million sales transactions valued in the aggregate at over $1 trillion; and
- Over 1.8 million high-resolution digital images, including building photographs, aerial photographs, plat maps and floor plans.

This highly complex database is comprised of hundreds of data fields, tracking such categories as:

- Location
- Site and zoning information
- Building characteristics
- Space availability
- Tax assessments
- Ownership
- Sales and lease comparables
- Space requirements
- Mortgage and deed information
- For-sale information
- Income and expense histories
- Tenant names
- Lease expirations
- Contact information
- Historical trends
- Demographic information

CoStar Research

We have developed a sophisticated data collection organization utilizing a multi-faceted research process. In 2003, our researchers drove over one million miles, conducted hundreds of thousands of on-site building inspections, examined tens of millions of public records and interviewed millions of tenants, owners and brokers.

Research Department. As of December 31, 2003, we employed over 550 commercial real estate research professionals. Our research professionals undergo an extensive training program to maintain consistent research methods and processes. Our researchers collect and analyze commercial real estate information through millions of phone calls, e-mails, Internet updates and faxes each year, in addition to field inspections, public records review, news monitoring and direct mail. Each researcher is responsible for maintaining the accuracy and reliability of the database. As part of their update process, researchers develop cooperative relationships with industry professionals that allow them to gather useful information. Because of the importance commercial real estate professionals place on our data and our prominent position in the industry, many of these professionals routinely take the initiative and proactively report available space and transactions to our researchers.

CoStar has an extensive field research effort that permits physical inspection of properties in order to find additional inventory, photograph properties and verify existing information. Some of these researchers use CoStar trucks equipped with Global Positioning Systems, which use satellites to keep track of the truck's location and pinpoint building locations. Each CoStar truck uses wireless technology to track and transmit field data. A dispatch center in the Company's Bethesda office manages the entire day-to-day U.S. field operations while using tracking software to monitor each researcher's progress. As of December 31, 2003, CoStar had 41 trucks used by field researchers in markets throughout the United States. A typical site inspection consists of photographing the building, measuring the building (if necessary), capturing "For Lease" sign information, counting parking spaces, assessing property condition and construction, and gathering tenant information. Certain researchers canvass properties, interviewing tenants suite by suite. Other researchers conduct fieldwork in county courthouses and public records offices. In addition, many of our field researchers are photographers who take photographs of commercial real estate properties to add to the collection of CoStar's digital images in our database.

Data Providers. We license a small portion of our data from public record providers and third-party data sources. Licensing agreements with these entities provide for our use of a variety of commercial real estate information, including property ownership, tenant information, maps and aerial photographs, all of which enhances various CoStar services. These license agreements generally grant us a non-exclusive license to use the data and images in the creation and supplementation of our information services and include what we believe are standard terms, such as a contract term ranging from two to three years, automatic renewal of the contract and fixed periodic license fees or a combination of fixed periodic license fees plus additional fees based upon our usage.

Management and Quality Control Systems. Our research processes include automated and non-automated controls to ensure the integrity of the data collection process. A large number of automated data quality tests check for potential errors, including occupancy date conflicts, available square footage greater than building area, typical floor space greater than land area and expired leases. We also monitor changes to critical fields of information to ensure all information is kept in compliance with our standard definitions and methodology. Our non-automated quality control procedures include:

- calling our information sources on recently-updated properties to re-verify information;
- reviewing commercial real estate periodicals for transactions to cross-check our research;
- performing periodic research audits and field checks to determine if we correctly canvassed all buildings;
- providing training and retraining to our research professionals to ensure accurate data compilation; and
- compiling measurable performance metrics for research teams and managers for feedback on data quality.

Finally, one of the most important and effective quality control measures we rely on is feedback taken from the commercial real estate professionals using our data every day.

Proprietary Technology

In-House Product Development and Information Technology Team. As of December 31, 2003, CoStar had a staff of 82 product development and information technology professionals who focus on developing and creating enhanced services, designing systems to ensure continuous improvement in data quality, improving the speed of data delivery, and building infrastructure capable of supporting CoStar's comprehensive database and image library. In 2003, the product development team released a variety of new services, including CoStar Property Express, which provides on-demand access to CoStar's national database of office and industrial properties for lease and for sale, and the first online version of CoStar Professional Directory, which provides CoStar Property Professional subscribers with access to detailed contact information for over 300,000 commercial real estate professionals. During 2003, the product development team also completed the transition of our subscription-based information services from desktop applications to the fully Web-based technology platform initially released in December 2002. This group also regularly implements service enhancements, including expanded features and new graphic designs.

Our information technology team is responsible for developing the infrastructure to appropriately support CoStar's business and our large and complex database. On an ongoing basis, these professionals develop and modify internal applications and systems to implement efficiencies and controls that produce quality improvements to the database, including increases to the speed of data collection, quality control review and data delivery. The team continues to develop and modify our enterprise-wide customer relationship management software application that integrates CoStar sales, research, customer support and accounting information with the management of customer contact histories, client subscriptions and usage, account authentication and client billing. The system also enables us to mine data so as to assess pricing policies, service feature usage and employee productivity.

We maintain Windows, Unix and Lotus Notes servers to support the database and an internal encrypted virtual private network to allow remote researchers real-time access to the database. We store full data back-ups off-site.

Services

Our suite of information services is branded and marketed to our customers. Our services are derived from a database of building-specific information and offer customers specialized tools for accessing, analyzing and using our information. Over time, we expect to enhance our existing information services and develop additional services that make use of our comprehensive database to meet the needs of our existing customers as well as potential new categories of customers.

Our various information services are described in detail in the following paragraphs.

CoStar Property Professional™. CoStar Property Professional is the Company's flagship service. It provides subscribers a comprehensive inventory of office, industrial and retail properties in 50 U.S. markets, including for-lease and for-sale listings, historical data, building photographs, maps and floor plans. Commercial real estate professionals use CoStar Property to identify available space for lease, evaluate leasing and sale opportunities, value assets and position properties in the marketplace. Our clients also use CoStar Property to analyze market conditions by calculating current vacancy rates, absorption rates or average rental rates, and forecasting future trends based on user-selected variables. CoStar Property provides subscribers with powerful map-based search capabilities as well as a user-controlled, password-protected extranet (or electronic "file cabinet") where brokers may share space surveys and deal-related documents online in real time with team members. When used together with CoStar Connect, CoStar Property enables subscribers to share space surveys and deal-related documents with their clients, accessed through their corporate web site. CoStar Property, along with all of CoStar's other core information services, are delivered solely via the Internet. In 2003, CoStar discontinued its development and support of all previous desktop versions of CoStar Property.

CoStar Property Express™. CoStar Property Express provides access, on-demand with a credit card or via an annual subscription, to a "light" or scaled-down version of CoStar Property. Commercial real estate professionals use CoStar Property Express to look up and search for-lease and for-sale listings in CoStar's comprehensive national database. CoStar Property Express provides base-building information, photos, floor plans, maps and a limited number of reports. When accessed on demand with a credit card, customers can perform searches, view properties and print reports during a 24-hour period. With an annual subscription, customers can perform an unlimited number of searches and view and print an unlimited number of listings in the individual markets licensed by their subscription.

CoStar COMPS Professional™. CoStar COMPS Professional provides comprehensive, national coverage of comparable sales information in the U.S. commercial real estate industry. It is the industry's most comprehensive database of comparable sales transactions and is designed for professionals who need to research property comparables, identify market trends, expedite the appraisal process and support property valuations.

CoStar COMPS Express™. CoStar COMPS Express provides users with immediate, subscription-free access with a credit card to the *CoStar COMPS Professional* system on a report-by-report basis. Subscribers also use this on-demand service to research comparable sales information outside of their subscription markets.

CoStar Tenant®. CoStar Tenant is a detailed online business-to-business prospecting and analytical tool providing commercial real estate professionals with the most comprehensive real estate-related U.S. tenant information available. CoStar Tenant profiles tenants occupying space in commercial buildings across the United States and provides updates on lease expirations — one of the service's key features — as well as occupancy levels, growth rates and numerous other facts. Delivering this information via the Internet allows users to target prospective clients quickly through a searchable database that identifies only those tenants meeting certain criteria. CoStar Tenant subscribers can also obtain credit reports through CoStar Tenant directly from D&B®. In 2003, the Company discontinued its development and support of all previous desktop versions of CoStar Tenant.

FOCUS. Our U.K. subsidiary, Property Intelligence plc, offers several services under the trade name FOCUS. The primary service, New FOCUS, is a digital online service offering information on the U.K. commercial real estate market. This service seamlessly links data on individual properties and companies including comparable sales, available space, requirements, tenants, lease deals, planning information, socio-economics and demographics, credit ratings, photos and maps across the United Kingdom. New FOCUS is an entirely web-based service.

CoStar Exchange®. CoStar Exchange is an online marketplace for buying and selling U.S. commercial properties. The Company believes CoStar Exchange is the only industry database that combines for-sale listings with correlating data on space availability, tenants, comparable sales and digital images, enabling professionals to post and search for properties quickly and efficiently. The information is distributed through a broker-centric model on a secure web-based browser and represents an efficient means for sellers to reach a large pre-qualified audience and for buyers to more effectively identify target properties.

CoStar Connect™. CoStar Connect allows commercial real estate firms to license CoStar's technology and information to market their U.S. property listings on their corporate web sites. Customers enhance the quality and depth of their listing information through access to CoStar's database of content and digital images. The service automatically updates and manages customers' online property information, providing comprehensive listings coverage and significantly reducing their expense of building the web site content and functionality. When used in tandem with CoStar Property Professional, CoStar Connect enables commercial real estate brokers to share surveys and documents online with their clients, accessed through the customer's company website.

CoStar Advertising™. In 2004, CoStar released a new advertising service that offers property owners a highly targeted and cost-effective way to market a vacant space directly to the brokers looking for that type of space. Our advertising model is based on varying levels of exposure, enabling the advertiser to target as narrowly or broadly as its budget permits. With the CoStar Advertising program, when the advertiser's listings appear in a results set, they receive priority positioning and are enhanced to stand out. The advertiser can also purchase exposure in additional submarkets, or the entire market area so that his ad will appear even when his listing would not be returned in a results set.

CoStar Professional Directory™. CoStar Professional Directory, a service available exclusively to CoStar Property Professional subscribers, provides detailed contact information for over 300,000 commercial real estate professionals, including specific information about an individual's current and prior activities such as completed transactions, current landlord representation assignments, sublet listings, major tenants and owners represented and local and national affiliations. Commercial real estate brokers can input their biographical information and credentials and upload their photo to create personal profiles. Subscribers use CoStar Professional Directory to network with their peers and identify and evaluate potential business partners, and maintain accurate mailing lists of other industry professionals for their direct mail marketing efforts.

CoStar Market Report™. The CoStar Market Report provides in-depth current and historical analytical information covering approximately 40 of the major metropolitan office and industrial markets in the United States. Published quarterly, each market report includes details such as absorption rates, vacancy rates, rental rates, average sales prices, capitalization rates, existing inventory and current construction activity. This data is presented using standard definitions and calculations developed by CoStar, and offers real estate professionals critical and unbiased information necessary to make intelligent commercial real estate decisions. CoStar Market Reports are available to CoStar Property Professional subscribers at no additional charge, and are available for purchase by nonsubscribers.

Metropolis™. The Metropolis service is a single interface that combines commercial real estate data from multiple information providers into a comprehensive resource. The Metropolis service allows a user to input a property address and then view detailed information on that property from multiple information providers, including CoStar services. This technology offers commercial real estate professionals a simple and convenient solution for integrating a wealth of third-party information and proprietary data, and is currently available for the Southern California markets.

CoStar ARES®. CoStar ARES is a leading real estate-related contact management solution and business development tool for commercial real estate professionals. It is a commercial real estate specific add-on to ACT! 6.0, a leading sales software program. As a value-added application, ARES is used as a customizable office-wide repository for contacts, property listings and comparables and provides importing of data from other CoStar subscription services.

CoStar News™. Our web site, our CoStar services and our e-mail news dispatches have become an accepted source of reliable industry news. In 2003, we published over 8,300 news stories. Our news services keep clients informed of late-breaking commercial real estate news such as major leasing transactions, acquisitions, new construction activity, key industry personnel moves and industry events.

Clients

We draw clients from across the commercial real estate and related business community. Commercial real estate brokers have traditionally formed the largest portion of CoStar clients, however, we also provide services to owners, landlords, financial institutions, vendors, appraisers, investment banks and other parties involved in commercial real estate. The following chart lists U.S. clients that are well known or have the highest annual subscription fees in each of the various categories and also lists U.K. clients that are well known or have the highest annual subscription fees in each of the various categories, each as of December 31, 2003.

Brokers

CB Richard Ellis
Colliers
Colliers Conrad Ritblat Erdman — U.K.
Cushman & Wakefield
Cushman & Wakefield Healey & Baker — U.K.
Trammell Crow Co.
Jones Lang LaSalle
Jones Lang LaSalle — U.K.
Grubb & Ellis
Marcus & Millichap
The Staubach Company
Newmark & Company Real Estate
CRESA Partners
Studley
Coldwell Banker Commercial
Equis
GVA Williams
Advantis GVA Real Estate Services
Binswanger
Carter & Associates / ONCOR Int'l
United Systems Integrators Corp
Daum Commercial Real Estate
Finkelstein Comm Rlty Services
U.S. Equities Realty
CMD Realty Investors
The Garibaldi Group
Ritchie Commercial
Mohr Partners
Friedman Real Estate
GVA Grimley — U.K.
King Sturge — U.K.
Knight Frank — U.K.
Donaldsons — U.K.
Chestertons — U.K.
FPD Savills — U.K.
Atis Real Weatheralls— U.K.
Re/Max

Lenders, Investment Bankers

GMAC Commercial Mortgage
GMAC—U.K.
Deutsche Bank
Wells Fargo
Washington Mutual
Wachovia Corporation
Merrill Lynch
World Savings
Fannie Mae
UBS Warburg — U.K.

Owners and Developers

Hines
LNR Property Corp
Shorenstein Properties
Gale Companies
Manulife Financial
Industrial Developments International
Land Securities — U.K.
Slough Estates — U.K.

REITS

Equity Office Properties Trust
Trizec Properties, Inc.
Prologis
Prentiss Properties
CarrAmerica
Boston Properties
First Industrial Realty Trust
Vornado Realty Trust

Property Managers

Transwestern Property Co.
Lincoln Property Company
PM Realty Group
Navisys Group
Osprey Management Company
Leggat McCall Properties

Institutional Advisors, Asset Managers

Jones Lang LaSalle
Prudential
Prudential — U.K.
Metropolitan Life
Clarion Partners
Bear Stearns & Co., Inc.
USAA Real Estate Company
Morley — U.K.
Legg Mason
Standard Life — U.K.

Appraisers, Accountants

Integra
Deloitte and Touche
Land America Onestop
Marvin F. Poer
KPMG
GE Capital Small Business Finance Corp
PGP Valuation
PricewaterhouseCoopers

Government Agencies

U.S. General Services Administration
County of Los Angeles
Office of Technology Procurement
City of Chicago
Cook County Assessor's Office
U.S. Department of Housing and Urban Development
Corporation of London— U.K.

Vendors

Turner Construction Company
Kastle Systems
Comcast Cable Communications
Cisco Systems
MWB — U.K.
Regus — U.K.

For the years ended December 31, 2001, 2002 and 2003, no single client accounted for more than 5% of our revenues. Our subscription-based information services currently generate over 90% of our total revenues. Our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Please see Note 3 to the Consolidated Financial Statements included herein for the financial information about the Company's geographic areas.

Sales and Marketing

As of December 31, 2003, we had 149 sales, marketing and customer support employees, with the majority of our direct sales force located in field sales offices. Our sales teams are primarily located in over 30 field sales offices throughout the United States and in London, England. In 2003, we also began using a centralized inside sales team at our Bethesda, Maryland headquarters that prospects for new clients and performs service demonstrations exclusively by telephone and over the Internet.

Our local offices typically serve as the platform for our in-market sales, customer support and field research operations for their respective regions. The sales force is responsible for selling to new prospects, training new and existing clients, providing ongoing customer support, renewing existing client contracts and identifying cross-selling opportunities. In addition, the sales force has primary front-line responsibility for customer care.

Our sales strategy is to aggressively attract new clients, while providing ongoing incentives for existing clients to subscribe to additional services. We also place a premium on training new and existing client personnel on the use of our services so as to promote maximum client utilization and satisfaction with our services. Our strategy also involves entering into multi-year, multi-market license agreements with our larger clients. In 2003, we signed multi-year, multi-market renewal agreements with CB Richard Ellis, Jones Lang LaSalle and Colliers International. These license agreements grant non-exclusive licenses to these companies' employees to use a variety of our information services. They typically have terms of a minimum of one year, generally renew automatically and require the payment of fixed monthly license fees.

We seek to make our services essential to our clients' businesses. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. In 2003, we released our CoStar Property Express service, which together with CoStar COMPS Express, offers clients on demand access to CoStar's database of commercial real estate information without requiring a subscription.

Our customer service and support staff is charged with assisting and training our client base, as well as ensuring high client satisfaction by providing ongoing customer support.

Our primary marketing methods include: service demonstrations, face to face networking, direct marketing, communication via our corporate web site and news services, participation in trade show and industry events, print advertising in trade magazines and local business journals, client referrals and CoStar Advisor™, the Company's newsletter that is distributed to our clients. In 2003, we conducted several focus groups comprised of commercial real estate professionals from various markets within the United States in an effort to garner feedback on how we could improve our services. Direct marketing is the most cost-effective means for us to find prospective clients. Our direct marketing efforts include direct mail and telemarketing, and make extensive use of our unique, proprietary database. Once we have identified a prospective client, our most effective sales method is a service demonstration. We use various forms of advertising to build brand identity and reinforce the value and benefits of our services. We also sponsor and attend local association activities and events, and attend and/or exhibit at industry trade shows and conferences to reinforce our relationships with our core user groups.

Competition

The market for information services generally is competitive and rapidly changing. In the commercial real estate industry, the principal competitive factors for commercial real estate information services and providers are:

- quality and depth of the underlying databases;
- ease of use, flexibility, and functionality of the software;
- timeliness of the data;
- breadth of geographic coverage and services offered;
- client service and support;
- perception that the service offered is the industry standard;
- proprietary nature of methodologies, databases and technical resources;
- price;
- effectiveness of marketing and sales efforts;
- vendor reputation;
- brand loyalty among customers; and
- capital resources.

We compete directly and indirectly for customers with the following categories of companies:

- publishers and distributors of information services, including regional providers and national print publications, such as Egi, Black's Guide and Dorey Publishing and Information Services;

- locally controlled real estate boards, exchanges or associations sponsoring property listing services and the companies with whom they partner, such as the Commercial Association of Realtors Data Services, the Association of Industrial Realtors, Commercial Search, LLC and Xceligent;

- online services or web sites targeted to commercial real estate brokers, buyers and sellers of commercial real estate properties, insurance companies, mortgage brokers and lenders, such as Cityfeet.com, Inc., officespace.com, TenantWise, Inc. and LoopNet, Inc.;

- in-house research departments operated by commercial real estate brokers;

- consortiums of real estate companies formed to explore opportunities in technology; and

- public record providers.

As the commercial real estate information marketplace develops, additional competitors (including companies which could have greater access to data, financial, product development, technical, or marketing resources than we do) may enter the market and competition may intensify. While we believe that we have successfully differentiated ourselves from existing competitors, competition could materially harm our business.

Proprietary Rights

To protect our proprietary rights in our methodologies, database, software, trademarks and other intellectual property, we depend upon a combination of:

- trade secret, copyright, trademark, database protection and other laws;
- nondisclosure, noncompetition and other contractual provisions with employees and consultants;
- license agreements with customers;
- patent protection; and
- technical measures.

We seek to protect our software's source code and our database as trade secrets and under copyright law. Although copyright registration is not a prerequisite for copyright protection, we have filed for copyright registration for many of our databases, software and other materials. Under current U.S. law, the arrangement and selection of data may be protected, but the actual data itself may not be. In addition, with respect to our U.K. databases, certain database protection laws provide additional protections of these databases. We license our services under license agreements that grant our clients non-exclusive, non-transferable licenses. These agreements restrict the disclosure and use of our information and prohibit the unauthorized reproduction or transfer of the information services we license.

We also attempt to protect the secrecy of our proprietary database, our trade secrets and our proprietary information through confidentiality and noncompetition agreements with our employees and consultants. Our services also include technical measures to discourage and detect unauthorized copying of our intellectual property.

We have filed trademark applications to register trademarks for a variety of names for the CoStar services and other marks, and have obtained registered trademarks for a variety of our marks, including “CoStar”, “COMPS”, “CoStar Property”, “CoStar Tenant”, “CoStar Exchange” and “CoStar Group”. In addition, we have filed patent applications covering certain of our methodologies and software.

Employees

As of December 31, 2003, we employed 853 employees. None of our employees is represented by a labor union. We have experienced no work stoppages. We believe that our employee relations are excellent.

Available Information

Our investors relations Internet web site is http://www.costar.com/corporate/investor. The reports we file with or furnish to the Securities and Exchange Commission, including our annual report, quarterly reports and current reports, are available free of charge on our Internet web site as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

Item 2. Properties

Our corporate headquarters are located in Bethesda, Maryland, where we occupy approximately 60,000 square feet of office space under a lease that expires on March 14, 2010.

In addition to our Bethesda, Maryland facility, our research operations are headquartered in leased spaces in San Diego, California, Cincinnati, Ohio and London, England. Additionally, we lease office space in a variety of other metropolitan areas, which generally house our field sales offices. These locations include, without limitation, the following: New York; Los Angeles; Chicago; San Francisco; Boston; Orange County, California; Philadelphia; Houston; Atlanta; Phoenix; Detroit; Pittsburgh; Cranford, New Jersey; Charlotte; Miami; Seattle; Denver; Austin; Dallas; Sacramento; Kansas City; Cleveland; Tustin, California; Tampa; Jacksonville; Indianapolis; Baltimore; Raleigh/Durham; St. Louis; Columbus, Ohio; and Portland, Oregon.

We believe these facilities are suitable and appropriately support our business needs.

Item 3. Legal Proceedings

Currently, and from time to time, we are involved in litigation incidental to the conduct of our business. We are not a party to any lawsuit or proceeding that, in the opinion of our management, is likely to have a material adverse effect on our financial position or results of operations.

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

We did not submit any matters to a vote of our security holders during the quarter ended December 31, 2003.

PART II

Item 5. Market for the Registrant's Common Stock and Related Stockholder Matters

Price Range of Common Stock. Our common stock is traded on the Nasdaq Stock Market® under the symbol "CSGP." The following table sets forth, for the periods indicated, the high and low sale price per share of our common stock on the Nasdaq Stock Market®.

	High	Low
Year Ended December 31, 2002		
First Quarter	$ 26.10	$ 16.01
Second Quarter	$ 25.34	$ 19.60
Third Quarter	$ 24.52	$ 17.11
Fourth Quarter	$ 19.49	$ 15.84
Year Ended December 31, 2003		
First Quarter	$ 22.65	$ 17.77
Second Quarter	$ 30.54	$ 21.27
Third Quarter	$ 31.90	$ 26.07
Fourth Quarter	$ 42.85	$ 26.89

As of March 1, 2004, there were 82 holders of record of our common stock. On December 31, 2003, the last sale price reported on the Nasdaq Stock Market® for our common stock was $41.70 per share.

Dividend Policy. We have never declared or paid any dividends on our common stock. Any future determination to pay dividends will be at the discretion of our Board of Directors, subject to applicable limitations under Delaware law, and will be dependent upon our results of operations, financial condition and other factors deemed relevant by our Board of Directors. The Company does not anticipate paying any dividends on its common stock during the foreseeable future, but intends to retain any earnings for future growth of its business.

Recent Issues of Unregistered Securities. We did not issue any unregistered securities during the quarter ended December 31, 2003.

Item 6. Selected Consolidated Financial and Operating Data

Selected Consolidated Financial and Operating Data
(in thousands, except per share data and other operating data)

The following table provides selected consolidated financial and other operating data for the five years ended December 31, 2003. The Consolidated Statement of Operations Data shown below for each of the three years ended December 31, 2003 and the Consolidated Balance Sheet Data as of December 31, 2002 and 2003 are derived from audited consolidated financial statements that are included in this report. The Consolidated Statement of Operations Data for each of the years ended December 31, 1999 and 2000 and the Consolidated Balance Sheet Data as of December 31, 1999, 2000 and 2001 shown below are derived from audited consolidated financial statements for those years that are not included in this report.

	Fiscal Year Ended December 31,				
Consolidated Statement of Operations Data:	**1999**	**2000**	**2001**	**2002**	**2003**
Revenues	$ 30,234	$ 58,502	$ 72,513	$ 79,363	$ 95,105
Cost of revenues	13,244	30,202	30,316	28,012	30,742
Gross margin	16,990	28,300	42,197	51,351	64,363
Operating expenses	32,373	83,335	64,923	56,894	64,361
Income (loss) from operations	(15,383)	(55,035)	(22,726)	(5,543)	2
Other income, net	3,106	3,335	1,578	759	380
Income (loss) before income taxes	(12,277)	(51,700)	(21,148)	(4,784)	382
Income tax expense (benefit)	—	(2,045)	(987)	—	282
Net income (loss)	$ (12,277)	$ (49,655)	$ (20,161)	$ (4,784)	$ 100
Net income (loss) per share – basic and diluted	$ (1.05)	$ (3.28)	$ (1.29)	$ (0.30)	$ 0.01
Weighted average shares outstanding – basic	11,727	15,137	15,636	15,759	16,202
Weighted average shares outstanding – diluted	11,727	15,137	15,636	15,759	16,674

	As of December 31,				
Consolidated Balance Sheet Data:	**1999**	**2000**	**2001**	**2002**	**2003**
Cash, cash equivalents, cash held for acquisition and short-term investments	$ 94,074	$ 47,101	$ 42,002	$ 43,530	$ 97,449
Working capital	89,153	35,601	33,315	36,993	88,207
Total assets	136,905	145,871	123,646	118,907	183,900
Total liabilities	17,208	19,497	15,627	14,890	15,531
Stockholders' equity	119,697	126,374	108,019	104,017	168,369

	As of December 31,				
Other Operating Data:	**1999**	**2000**	**2001**	**2002**	**2003**
Markets covered by database	41	51	50	50	51
Number of subscription client sites	3,612	5,407	6,356	6,907	8,582
Billions of square feet in database	15.6	21.7	23.0	25.0	27.7
Buildings in database	334,917	864,920	950,000	1,033,000	1,521,000
Images in database	349,526	968,316	1,300,000	1,500,000	1,805,000

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements," including statements about our beliefs and expectations. There are many risks and uncertainties that could cause actual results to differ materially from those discussed in the forward-looking statements. Potential factors that could cause actual results to differ materially from those discussed in any forward-looking statements include, but are not limited to, those stated below under the headings "Cautionary Statement Concerning Forward-Looking Statements" and "Risk Factors" as well as those described from time to time in our filings with the Securities and Exchange Commission.

All forward-looking statements are based on information available to us on the date of this filing, and we assume no obligation to update such statements. The following discussion should be read in conjunction with our filings with the Securities and Exchange Commission and the consolidated financial statements included in this Annual Report.

Overview

CoStar is the leading provider of information services to the commercial real estate industry in the United States and the United Kingdom based on the fact that we offer the most comprehensive commercial real estate database available, have the largest research department and the most clients in the industry, provide more information services than any of our competitors and believe we generate more revenues than any of our competitors. We have created a standardized information platform where the members of the commercial real estate and related business community can continuously interact and facilitate transactions by efficiently exchanging accurate and standardized commercial real estate information. Our integrated suite of online service offerings includes information about space available for lease, comparable sales information, tenant information, information about properties for sale, information for clients' web sites, information about industry professionals and their business relationships, analytic information, data integration, property marketing, organizational tools for contact and property information and industry news.

We completed our initial public offering in July 1998, and received net proceeds of approximately $22.7 million. We used those net proceeds to fund the geographic and service expansion of our business, including three strategic acquisitions, and to expand our sales and marketing organization. In May 1999, we completed a follow-on public offering and received net proceeds of approximately $97.4 million. We used a portion of those net proceeds to fund the acquisitions of COMPS.COM, Inc. ("Comps") and Property Intelligence plc ("Property Intelligence"). In November 2003, we completed an additional follow-on public offering and issued 1,667,500 shares of common stock and received net proceeds of approximately $53.5 million. We expect to use the remainder of the proceeds from these public offerings for development and distribution of new services, expansion of existing services across our current markets, geographic expansion in the U.S. and international markets, strategic acquisitions, working capital and general corporate purposes.

From 1994 through the beginning of 2003, we expanded the geographical coverage of our existing information services and developed new information services. In addition to internal growth, this expansion included the acquisitions of Chicago ReSource, Inc. in Chicago in 1996 and New Market Systems, Inc. in San Francisco in 1997. In August 1998 we expanded into the Houston region through the acquisition of Houston-based real estate information provider C Data Services, Inc. In January 1999 we expanded further into the Midwest and Florida by acquiring LeaseTrend, Inc. and into Atlanta and Dallas/Fort Worth by acquiring Jamison Research, Inc. In September 1999 we acquired ARES Development Group, LLC, a Los Angeles-based developer and distributor of ARES for ACT!. In February 2000 we acquired Comps, a San Diego-based provider of commercial real estate information. In November 2000 we acquired First Image Technologies, Inc. ("First Image"). In September 2002 we expanded further into Portland, Oregon through the acquisition of certain of the assets of Napier Realty Advisors d/b/a REAL-NET ("REAL-NET"). In January 2003 we established a base in the United Kingdom with our acquisition of London-based Property Intelligence. The more recent acquisitions are discussed later in this section.

Since our inception, the growth of our business has required substantial investments for the expansion of our services and the establishment of operating regions throughout the United States, which resulted in substantial net losses on an overall basis until 2003. Throughout 1999 and 2000, we experienced a rapid expansion in the number of services that we offer and the number of regions in which we operate. By the beginning of 2001, we had substantially established a national platform of service offerings in 50 U.S. metropolitan markets from which we believe we can appropriately meet the commercial real estate community's needs for comprehensive U.S. building-specific information. From 2001 through 2003, we focused on continuing to grow revenue while controlling and reducing costs, in order to reduce operating losses and become profitable in accordance with accounting principles generally accepted in the United States ("GAAP"). During 2003, our GAAP net income increased from a net loss of $4.8 million for the year ended December 31, 2002 to net income of $100,000 for the year ended December 31, 2003. In addition, we increased EBITDA (net income before interest, taxes, depreciation and amortization) by $7.0 million from $6.2 million in 2002 to $13.2 million in 2003. Our use of non-GAAP financial measures is discussed later in this section.

Beginning in 2004, we plan to further expand into 21 new metropolitan markets throughout the United States as well as expand the geographical boundaries of many of our existing U.S. markets. The field research phase of this expansion is expected to start in the second quarter of 2004. We generally have not experienced this type of internal geographic expansion since 2000. Although we believe that a large component of our current operating cost structure is made up of fixed operating costs, our planned 2004 expansion will cause our cost structure to escalate in advance of revenues in these 21 new metropolitan markets, as we invest in future revenue growth opportunities for 2005 and beyond. In addition, the incremental costs of introducing new services in an existing market or increasing geographic coverage in an existing market may further increase our operating cost structure and reduce the profitability of an existing market prior to release of the additional service offerings or increasing market coverage.

We expect 2004 revenue to grow significantly over 2003 revenue as a result of expected further penetration of our services in our potential customer base across our platform, as well as the successful cross-selling of our services into our existing customer base. In addition, we expect 2004 EBITDA to significantly increase over 2003 EBITDA and 2004 GAAP net income to significantly increase over 2003 GAAP net income, each as a result of expected increased revenue growth coupled with a relatively fixed operating cost structure. If we achieve our expected revenue growth and maintain a relatively fixed operating cost structure, we believe we will maintain positive cash flow from operating activities throughout 2004.

Historically, our calculations of weighted-average outstanding shares for basic and diluted net loss per share have been identical because stock options that would have had an anti-dilutive effect on the calculation have been properly excluded from the calculation. We achieved GAAP-basis net income for the year ended December 31, 2003, and as a result our calculation of weighted-average outstanding shares for diluted net income per share includes the effect of any dilutive stock options, which are any outstanding stock options that have an exercise price lower than the average market price of our common stock for the year ended December 31, 2003. We expect that our diluted net income per share will be lower than our basic net income per share for any future periods in which we report GAAP-basis net income due to the dilutive effect of outstanding stock options. In addition, our calculation of weighted-average outstanding shares for basic and diluted net income per share for 2003 included the effect of the weighted-average outstanding shares related to our November 2003 follow-on public offering in which we issued approximately 1.7 million shares of our common stock. As a result of this share issuance, we expect our calculation of weighted-average outstanding shares for basic and diluted net income per share for 2004 to significantly increase compared to our calculation of weighted-average outstanding shares for basic and diluted net income per share for 2003.

In addition, we achieved taxable income in the third and fourth quarters of 2003, which enabled us to utilize some of our net operating loss carryforwards for tax purposes. Although our net operating loss carryforwards are substantial, we are subject to limitations on their use. In addition, we are subject to Federal alternative minimum taxes and state and local tax jurisdictions may not recognize portions of these loss carryforwards. As a result, we incurred income tax expense for the year ended December 31, 2003 and expect to incur income tax expense in the future.

We continue to develop and distribute new services, expand existing services across our U.S. and U.K. markets and expand the geographic boundaries of our current markets. The incremental cost of introducing new services, expanding existing services, or expanding geographic boundaries in the future may reduce the profitability of a region or cause it to incur losses. In addition to our planned geographic expansion into 21 new metropolitan markets throughout the United States, we may continue further geographic expansion in the United States or we may seek additional international geographic expansion. Any future significant geographic expansion could also significantly increase our capital expenditures. Therefore, while we expect current service offerings in existing regions to remain generally profitable and provide substantial funding for our overall business, it is possible that further overall expansion could cause us to generate losses and negative cash flow from operations in the future.

While our services continue to expand, our subscription-based information services, consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional and FOCUS services, currently generate over 90% of our total revenues. Our contracts for our subscription-based information services typically have a minimum term of one year and renew automatically. Upon renewal, many of the subscription contract rates may increase in accordance with contract provisions or as a result of contract renegotiations. To encourage clients to use our services regularly, we generally charge a fixed monthly amount for our subscription-based services rather than fees based on actual system usage. Contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Our subscription clients generally pay contract fees on a monthly basis, but in some cases may pay us on a quarterly or annual basis. We recognize this revenue on a straight-line basis over the life of the contract. Annual and quarterly advance payments result in deferred revenue, substantially reducing the working capital requirements generated by accounts receivable.

Prior to 2001, our contract renewal rate historically had exceeded 90% on an annual basis. For the year ended December 31, 2001, our renewal rate decreased to 83% as a result of the downturn in general economic conditions. Subsequent to 2001, our contract renewal rate has been increasing and for the year ended December 31, 2003, our contract renewal rate was 88%.

We applied the new rules on accounting for goodwill and intangible assets deemed to have indefinite lives beginning in the first quarter of 2002. In accordance with Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests. Other intangible assets continue to be amortized over their useful lives. The effect of the new rules decreased amortization expense related to goodwill by approximately $4.2 million for the year ended December 31, 2002 compared to the previous year.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. The following accounting policies involve a "critical accounting estimate" because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period. Changes in the accounting estimates we used are reasonably likely to occur from period to period which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary.

Valuation of long-lived and intangible assets and goodwill

We assess the impairment of long-lived assets, identifiable intangibles and goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- Significant underperformance relative to historical or projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business;
- Significant negative industry or economic trends; or
- Significant decline in our market capitalization relative to net book value for a sustained period.

When we determine that the carrying value of long-lived and identifiable intangible assets may not be recovered based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

Goodwill and identifiable intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently based upon the existence of one or more of the above indicators. We measure any impairment loss to the extent that the asset's carrying amount exceeds its fair value.

Accounting for income taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process requires us to estimate our actual current tax exposure and assess the temporary differences resulting from differing treatment of items, such as deferred revenue or deductibility of certain intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income. To the extent we believe the recovery is not reasonably assured, we must establish a valuation allowance. Going forward, we will assess the continued need for the valuation allowance. After we have determined that we will be able to begin utilizing a significant portion of the deferred tax assets, we may reverse the valuation allowance, resulting in a benefit to the statement of operations in some future period.

Accounting for employee stock options

As permitted under Statement of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation," we account for employee stock options in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees." Under APB No. 25, we recognize compensation cost based on the intrinsic value of the equity instrument awarded as determined at the measurement date. We disclose the required pro forma information in our notes to consolidated financial statements as if the fair value method prescribed by SFAS No. 123 had been applied.

Non-GAAP Financial Measures

We prepare and publicly release quarterly unaudited financial statements prepared in accordance with GAAP. We also disclose and discuss certain non-GAAP financial measures in our public releases. These non-GAAP financial measures include: EBITDA, which is our net income (loss) before interest, income taxes, depreciation and amortization; and pro forma earnings, which is our net income (loss) before purchase amortization in cost of revenues, purchase amortization in operating expenses and the related income tax benefit. We disclose EBITDA in our earnings releases, investor conference calls and filings with the Securities and Exchange Commission. We disclose pro forma earnings in our earnings releases and investor conference calls. The non-GAAP financial measures that we use may not be comparable to similarly titled measures reported by other companies. Also, in the future, we may disclose other non-GAAP financial measures in order to help our investors more meaningfully evaluate and compare our future results of operations to our previously reported results of operations.

We view EBITDA and pro forma earnings as operating performance measures and as such we believe that the GAAP financial measure most directly comparable to them is net income (loss). In calculating EBITDA and pro forma earnings, we exclude from net income (loss) the financial items that we believe should be separately identified to provide additional analysis of the financial components of the day-to-day operation of our business. We have outlined below the type and scope of these exclusions and the material limitations on the use of these non-GAAP financial measures as a result of these exclusions. EBITDA and pro forma earnings are not measurements of financial performance under GAAP and should not be considered as measures of liquidity, as alternatives to net income (loss) or as indicators of any other measure of performance derived in accordance with GAAP. Investors and potential investors in our securities should not rely on EBITDA and pro forma earnings as a substitute for any GAAP financial measure, including net income (loss). In addition, we urge investors and potential investors in our securities to carefully review the reconciliation of EBITDA to net income (loss) set forth below and to carefully review the GAAP financial information included as part of our Quarterly Reports on Form 10-Q and our Annual Reports on Form 10-K that are filed with the Securities and Exchange Commission, as well as our quarterly earnings releases, and compare the GAAP financial information with our EBITDA and pro forma earnings.

EBITDA and pro forma earnings are used by management to internally measure our operating and management performance and by investors as supplemental financial measures to evaluate the performance of our business that, when viewed with our GAAP results and the accompanying reconciliation, we believe provide additional information that is useful to gain an understanding of the factors and trends affecting our business. We have spent more than 16 years building our database of commercial real estate information and expanding our markets and services partially through acquisitions of complimentary businesses. Due to the expansion of our information services, which included acquisitions, our net income (loss) includes significant charges for purchase amortization, depreciation and other amortization. EBITDA and pro forma earnings, which exclude these charges, provide meaningful information about the operating performance of our business, apart from charges for purchase amortization, depreciation and other amortization. We believe the disclosure of EBITDA and pro forma earnings helps investors meaningfully evaluate and compare our performance from quarter to quarter and from year to year. We also believe EBITDA and pro forma earnings are measures of our ongoing operating performance because the isolation of non-cash charges, such as amortization and depreciation, and non-operating items, such as interest and income taxes, provides additional information about our cost structure, and, over time, helps track our operating progress. In addition, investors, securities analysts and others regularly rely on EBITDA and pro forma earnings to provide a financial measure by which to compare our operating performance against that of other companies in our industry. Finally, management and the Board of Directors use pro forma earnings as one of several criteria to determine the achievement of performance-based cash bonuses.

Set forth below are descriptions of the financial items that have been excluded from our net income (loss) to calculate EBITDA and pro forma earnings and the material limitations associated with using these non-GAAP financial measures as compared to net income (loss):

- Purchase amortization in cost of revenues may be useful for investors to consider because it represents the use of our acquired database technology, which is one of the sources of information for our database of commercial real estate information. We do not believe these charges reflect the current and ongoing cash charges related to our operating cost structure.

- Purchase amortization in operating expenses may be useful for investors to consider because it represents the estimated attrition of our acquired customer base and the diminishing value of any acquired tradenames. We do not believe these charges reflect the current and ongoing cash charges related to our operating cost structure.

- Depreciation and other amortization may be useful for investors to consider because they generally represent the wear and tear on our property and equipment used in our operations. We do not believe these charges reflect the current and ongoing cash charges related to our operating cost structure.

- The amount of net interest income and income taxes we generate may be useful for investors to consider and may result in current cash inflows or outflows. However, management does not consider the amount of net interest income or income taxes representative of the day-to-day operating performance of our business.

Management compensates for the above-described limitations of using non-GAAP measures by only using non-GAAP measures to supplement our GAAP results and to provide additional information that is useful to gain an understanding of the factors and trends affecting our business.

The following table shows our EBITDA reconciled to our GAAP net income (loss) and our cash flows from operating, investing and financing activities for the indicated periods (in thousands of dollars):

	Fiscal Year Ended December 31,		
	2001	2002	2003
Net income (loss)	$ (20,161)	$ (4,784)	$ 100
Purchase amortization in cost of revenues	5,398	2,866	2,777
Purchase amortization in operating expenses	7,846	3,600	4,487
Depreciation and other amortization	5,931	5,292	5,907
Interest income, net	(1,674)	(763)	(381)
Income tax expense	(987)	—	282
EBITDA	$ (3,647)	$ 6,211	$ 13,172
Cash flows provided by (used in)			
Operating activities	$ (4,548)	$ 5,574	$ 13,550
Investing activities	(10,348)	(11,470)	(65,521)
Financing activities	1,717	696	61,759

Consolidated Results of Operations

The following table provides our selected consolidated results of operations for the indicated periods (in thousands of dollars and as a percentage of total revenue):

	Fiscal Year Ended December 31,					
	2001		2002		2003	
Revenues	$ 72,513	100.0 %	$ 79,363	100.0 %	$ 95,105	100.0 %
Cost of revenues	30,316	41.8	28,012	35.3	30,742	32.3
Gross margin	42,197	58.2	51,351	64.7	64,363	67.7
Operating expenses:						
Selling and marketing	23,502	32.4	23,158	29.2	26,537	27.9
Software development	5,137	7.1	5,524	7.0	6,886	7.3
General and administrative	28,438	39.2	24,612	31.0	26,451	27.8
Purchase amortization	7,846	10.8	3,600	4.5	4,487	4.7
Total operating expenses	64,923	89.5	56,894	71.7	64,361	67.7
Income (loss) from operations	(22,726)	(31.3)	(5,543)	(7.0)	2	0.0
Other income, net	1,578	2.2	759	1.0	380	0.4
Income (loss) before income taxes	(21,148)	(29.1)	(4,784)	(6.0)	382	0.4
Income tax expense (benefit)	(987)	1.4	—	—	282	0.3
Net income (loss)	$ (20,161)	(27.7) %	$ (4,784)	(6.0) %	$ 100	0.1 %

Comparison of Year Ended December 31, 2003 and Year Ended December 31, 2002

Revenues. Revenues grew 19.8% from $79.4 million in 2002 to $95.1 million in 2003. This growth was the result of additional revenue from the Property Intelligence acquisition and further penetration of our subscription-based information services into our existing and potential customer base, as well as the successful cross-selling of information services into our existing customer base across our service platform. Revenues from our U.K. markets accounted for approximately 8% of revenues for the year ended December 31, 2003. Subscription-based information services consisting primarily of CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, and FOCUS services, currently generate over 90% of our total revenues.

Gross Margin. Gross margin increased from $51.4 million in 2002 to $64.4 million in 2003. Gross margin percentage also increased from 64.7% in 2002 to 67.7% in 2003. The increase in the gross margin percentage resulted principally from internal revenue growth from our subscription-based information services, which was slightly offset by the addition of margins from our U.K. markets averaging approximately 60%. Cost of revenues increased from $28.0 million in 2002 to $30.7 million in 2003, principally due to the addition of cost of revenues from our U.K. markets as a result of the Property Intelligence acquisition, which was slightly offset by a decrease in cost of revenues from our U.S. markets.

Selling and Marketing Expenses. Selling and marketing expenses increased from $23.2 million in 2002 to $26.5 million in 2003 and decreased as a percentage of revenues from 29.2% in 2002 to 27.9% in 2003. The increase in selling and marketing expenses was primarily due to the addition of approximately $1.4 million of selling and marketing expenses from our U.K. markets as a result of the Property Intelligence acquisition, increased sales and marketing personnel costs and marketing campaigns surrounding the release of our web-based CoStar Property Professional service.

Software Development Expenses. Software development expenses increased from $5.5 million in 2002 to $6.9 million in 2003 and increased as a percentage of revenues from 7.0% in 2002 to 7.3% in 2003. This increase was due to the addition of U.K. software development expenses as a result of the Property Intelligence acquisition and our continued focus on service enhancements and development as well as the support of internal information systems to manage the Company's growth.

General and Administrative Expenses. General and administrative expenses increased from $24.6 million in 2002 to $26.5 million in 2003 and decreased as a percentage of revenues from 31.0% in 2002 to 27.8% in 2003. The increase in the amount of general and administrative expenses was primarily due to the addition of $2.8 million for U.K. general and administrative expenses as a result of the Property Intelligence acquisition, which was offset by a decrease in general and administrative expenses from our U.S. markets primarily due to reductions in administrative headcount.

Purchase Amortization. Purchase amortization increased from $3.6 million in 2002 to $4.5 million in 2003. This increase was due to increased purchase price amortization of identified intangible assets resulting from the acquisition of Property Intelligence, and was partially offset by a decrease in purchase amortization resulting from the complete amortization of certain identified intangible assets during 2003.

Other Income, Net. Interest and other income decreased from $759,000 in 2002 to $380,000 in 2003. This decrease was primarily a result of lower total cash balances for the first three quarters of 2003, and lower interest rates during the year.

Income Tax Expense. Income tax expense increased from $0 in 2002 to $282,000 in 2003. This increase is a result of the fact that we achieved taxable income in the third and fourth quarters of 2003, which caused us to incur income tax expense. Our total income tax expense was partially offset through the use of some of our net operating loss carryforwards. Because we are subject to Federal alternative minimum taxes and because certain state and local tax jurisdictions do not currently recognize portions of our net loss carryforwards, we were not able to completely offset our income tax liability through the use of our net operating loss carryforwards.

Comparison of Year Ended December 31, 2002 and Year Ended December 31, 2001

Revenues. Revenues grew 9.4% from $72.5 million in 2001 to $79.4 million in 2002. This growth was principally the result of further penetration of our services in our potential customer base across our national platform, as well as the successful cross-selling of services into our existing customer base. Subscription based information services, including CoStar Property Professional, CoStar Tenant, CoStar COMPS Professional, CoStar Exchange and CoStar Connect, accounted for over 90% of the Company's revenues.

Gross Margin. Gross margin increased from $42.2 million in 2001 to $51.4 million in 2002. Gross margin as a percentage of revenues increased from 58.2% in 2001 to 64.7% in 2002. The increase in gross margin amount and percentage resulted from revenue growth combined with a reduction in cost of revenues. This reduction was principally due to a $2.5 million decrease in purchase price amortization resulting from the complete amortization of certain identified intangibles assets during the first quarter of 2002. This was somewhat offset by an increase in research personnel costs compared to the same period in 2001.

Selling and Marketing Expenses. Selling and marketing expenses decreased from $23.5 million in 2001 to $23.2 million in 2002 and decreased as a percentage of revenues from 32.4% in 2001 to 29.2% in 2002. During 2002, we significantly increased the size of our sales force for subscription-based information services. Although this growth occurred, selling and marketing expenses decreased during 2002 principally as a result of a reduction in overall operating costs associated with the sales organization, including travel and other personnel costs.

Software Development Expenses. Software development expenses increased from $5.1 million in 2001 to $5.5 million in 2002 and decreased as a percentage of revenues from 7.1% in 2001 to 7.0% in 2002. The increase in software development expenses reflects development costs for the increased number of services we now support. In addition, these costs reflect the support of internal information systems to manage the Company's growth.

General and Administrative Expenses. General and administrative expenses decreased from $28.4 million in 2001 to $24.6 million in 2002 and decreased as a percentage of revenues from 39.2% in 2001 to 31.0% in 2002. The decrease in the amount of general and administrative expenses is primarily due to reductions in administrative headcount, communications, consulting, travel costs and outside services during 2002.

Purchase Amortization. Purchase amortization decreased from $7.8 million in 2001 to $3.6 million in 2002. Purchase amortization decreased primarily due to the adoption of Statements of Financial Accounting Standards No. 141, "Business Combinations", and No. 142, "Goodwill and Other Intangible Assets". Under the new rules, goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests in accordance with the Standards. The effect of the new rules decreased amortization expense related to goodwill by approximately $4.2 million for 2002 as compared to 2001.

Other Income, Net. Interest and other income decreased from $1.6 million in 2001 to $759,000 in 2002. This decrease was primarily a result of lower total cash, cash equivalents and short-term investment balances and lower interest rates during the year.

Income Tax Benefit. Income tax benefit decreased from $987,000 in 2001 to $0 in 2002. This decrease was a result of the reversal of the deferred tax liability incurred in connection with the amortization of identified intangible assets acquired through acquisitions.

Consolidated Quarterly Results of Operations

The following tables summarize our consolidated results of operations on a quarterly basis for the indicated periods (in thousands, except per share amounts):

	2002				2003			
	Mar. 31	**Jun. 30**	**Sep. 30**	**Dec. 31**	**Mar. 31**	**Jun. 30**	**Sep. 30**	**Dec. 31**
Revenues	$ 19,061	$ 19,539	$ 20,075	$ 20,688	$ 22,553	$ 23,174	$ 24,108	$ 25,270
Cost of revenues	7,096	6,937	6,996	6,983	7,603	7,716	7,627	7,796
Gross margin	11,965	12,602	13,079	13,705	14,950	15,458	16,481	17,474
Operating expenses	13,826	14,083	14,387	14,598	15,870	15,881	16,107	16,503
Income (loss) from operations	(1,861)	(1,481)	(1,308)	(893)	(920)	(423)	374	971
Other income, net	239	214	183	123	77	56	65	182
Income (loss) before income taxes	(1,622)	(1,267)	(1,125)	(770)	(843)	(367)	439	1,153
Income tax expense (benefit)	—	—	—	—	—	—	158	124
Net income (loss)	(1,622)	(1,267)	(1,125)	(770)	(843)	(367)	281	1,029
Net income (loss) per share – basic and diluted	$ (0.10)	$ (0.08)	$ (0.07)	$ (0.05)	$ (0.05)	$ (0.02)	$ 0.02	$ 0.06

	2002				2003			
	Mar. 31	Jun. 30	Sep. 30	Dec. 31	Mar. 31	Jun. 30	Sep. 30	Dec. 31
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of revenues	37.2	35.5	34.9	33.8	33.7	33.3	31.7	30.9
Gross margin	62.8	64.5	65.1	66.2	66.3	66.7	68.3	69.1
Operating expenses	72.5	72.1	71.6	70.5	70.4	68.5	66.8	65.3
Income (loss) from operations	(9.7)	(7.6)	(6.5)	(4.3)	(4.1)	(1.8)	1.5	3.8
Other income, net	1.2	1.1	0.9	0.6	0.4	0.2	0.3	0.8
Income (loss) before income taxes	(8.5)	(6.5)	(5.6)	(3.7)	(3.7)	(1.6)	1.8	4.6
Income tax expense (benefit)	0.0	0.0	0.0	0.0	0.0	0.0	0.7	0.5
Net income (loss)	(8.5)%	(6.5)%	(5.6)%	(3.7)%	(3.7)%	(1.6)%	1.1%	4.1%

Recent Acquisitions

Real-Net. On September 19, 2002, we acquired certain assets of Portland-based commercial real estate information provider, REAL-NET, in a purchase business combination for $305,000 in cash. The purchase price was allocated primarily to acquired database technology and customer base. The acquired database technology is being amortized on a straight-line basis over 5 years. The customer base, which consists of one distinct intangible asset composed of acquired customer contracts and related customer relationships, is being amortized on a 125% declining balance method over a period of five years.

Property Intelligence. On January 6, 2003, we acquired the share capital of London-based Property Intelligence for the U.S. dollar equivalent of approximately $17.4 million, net of cash acquired of approximately $1.4 million. The acquisition has been accounted for using purchase accounting. The purchase price was principally allocated to cash and other working capital accounts, database technology, customer base and goodwill. The acquired database technology is being amortized on a straight-line basis over 5 years. The customer base, which consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over 10 years. Goodwill will not be amortized, but is subject to annual impairment tests. We are in the process of obtaining additional information regarding the income tax attributes and deferred taxes related to Property Intelligence to complete the purchase price allocation. Property Intelligence, whose operations principally consist of FOCUS services, is a leading provider of information services to the commercial real estate and related business community in the United Kingdom.

Liquidity and Capital Resources

Our principal sources of liquidity are cash, cash equivalents and short-term investments. Total cash, cash equivalents and short-term investments were $97.4 million at December 31, 2003 compared to $27.1 million at December 31, 2002. In addition, we had $16.4 million of cash held for acquisition as of December 31, 2002, which was used for the acquisition of Property Intelligence, which closed on January 6, 2003. From December 31, 2002 to December 31, 2003, cash, cash equivalents and short-term investments increased $70.3 million, principally as a result of our November 2003 follow-on public offering in which we issued 1,667,500 shares of common stock and received net proceeds of $53.5 million, net cash provided by operating activities of $13.6 million, and proceeds of $8.3 million from stock option exercises used to purchase approximately 395,000 shares of common stock, offset by cash purchases of property and equipment of approximately $3.9 million and the net outlay of cash for the Property Intelligence acquisition.

Net cash provided by operating activities for the year ended December 31, 2003 was $13.6 million compared to $5.6 million for the year ended December 31, 2002. This $8.0 million increase in net cash provided by operating activities was principally the result of revenue growth and resulting growth in gross margin, which contributed to reaching $100,000 of GAAP net income in 2003 compared to a GAAP net loss of $4.8 million in 2002. Additionally, improved account collections resulted in a reduction of approximately $2.3 million in accounts receivable, contributing to operating cash flow.

Net cash used in investing activities was $65.5 million for the year ended December 31, 2003 compared to $11.5 million for the year ended December 31, 2002. This $54.0 million increase in net cash used in investing activities was principally due to the increase in purchases of short-term investments from the proceeds of our November 2003 follow-on public offering and the net cash paid for the acquisition of Property Intelligence.

Net cash provided by financing activities was $61.8 million for the year ended December 31, 2003 compared to $696,000 for the year ended December 31, 2002. This $61.1 million increase in net cash provided by financing activities was principally the result of our November 2003 follow-on public offering in which we issued 1,667,500 shares of common stock and received net proceeds of $53.5 million as well as proceeds of $8.3 million from stock option exercises to purchase approximately 395,000 shares of common stock.

Contractual Obligations. The following table summarizes our principal contractual obligations at December 31, 2003 and the effect such obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

	Total	2004	2005 - 2006	2007 - 2008	2009 and thereafter
Operating leases	$ 26,307	$ 5,007	$ 10,484	$ 7,669	$ 3,147
Purchase obligations[(1)]	5,859	4,707	1,148	4	—
Total contractual principal cash obligations	$ 32,166	$ 9,714	$ 11,632	$ 7,673	$ 3,147

(1) Amounts included for the year 2005 and beyond do not include current purchase obligations that may be renewed on the same or different terms or terminated by us or a third party.

Capital expenditures for 2004 are expected to include investments in assets required to support our planned market expansion, including additional field research vehicles, building photography, initial databases, and communications, measuring, photographic and computer equipment, totaling approximately $5.5 million. Additionally, approximately $3.5 million to $4 million is planned to support existing operations, consistent with expenditures for the past several years.

To date, we have grown in part by acquiring other companies and we may continue to make acquisitions. Our acquisitions may vary in size and could be material to our current operations. We expect to use cash, stock, debt or other means of funding to make these acquisitions.

Based on current plans, we believe that our available cash combined with positive cash flow provided by operating activities should be sufficient to fund our operations for at least the next 12 months.

We achieved taxable income in the third and fourth quarters of 2003, which enabled us to utilize some of our net operating loss carryforwards for tax purposes. Although our net operating loss carryforwards are substantial, we are subject to limitations on their use. In addition, we are subject to Federal alternative minimum taxes and state and local tax jurisdictions that currently do not recognize portions of these loss carryforwards. As a result, we incurred income tax expense of approximately $282,000 during 2003.

We do not believe the impact of inflation has significantly affected our operations.

Recent Accounting Pronouncements

Effective January 1, 2003, we adopted Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"). SFAS 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of commitment to an exit or disposal plan. SFAS 146 replaces previous accounting guidance provided by Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)," and is effective for exit or disposal activities initiated after December 31, 2002. Adoption of this statement had no material impact on our consolidated financial position, consolidated results of operations, or liquidity.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" ("SFAS 148"). SFAS 148 amends Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 regardless of the accounting method used to account for stock-based compensation. We have chosen to continue to account for stock-based employee compensation using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. We have adopted the disclosure requirements of SFAS 123 and SFAS 148.

We believe that generally accepted accounting principles in the United States related to stock-based employee compensation may continue to change, with such changes including requiring companies to record stock-based compensation expense using the fair value method for the options granted to employees. Changes in these rules requiring us to record expense related to grants of stock options using the fair value method may reduce our GAAP net income results. Additionally, we are evaluating our compensation practices and may develop alternative stock-based employee compensation plans, including without limitation the issuance of restricted stock, which may result in recording additional expense to our consolidated statement of operations and reduce our GAAP net income.

Cautionary Statement Concerning Forward-Looking Statements

We have made forward-looking statements in this Report and make forward looking statements in our press releases and conference calls that are subject to risks and uncertainties. Forward-looking statements include information that is not purely historic fact and include, without limitation, statements concerning our financial outlook for 2004 and beyond, our possible or assumed future results of operations generally, and other statements and information regarding assumptions about our revenues, pro forma earnings, EBITDA, GAAP net income, taxable income, cash flow from operating activities, available cash, operating costs, amortization expense, intangible asset recovery, net income per share, diluted net income per share, weighted-average outstanding shares, capital and other expenditures, purchase amortization, financing plans, geographic expansion, capital structure, contractual obligations, legal proceedings and claims, our database, services and facilities, employee relations, future economic performance, management's plans, goals and objectives for future operations and growth and markets for our stock. The sections of this Report which contain forward-looking statements include "Business", "Properties", "Legal Proceedings", "Management's Discussion and Analysis of Financial Condition and Results of Operations", "Quantitative and Qualitative Disclosures About Market Risk" and the Financial Statements and related Notes.

Our forward-looking statements are also identified by words such as "believes," "expects," "thinks," "anticipates," "intends," "estimates" or similar expressions. You should understand that these forward-looking statements are necessarily estimates reflecting our judgment, not guarantees of future performance. They are subject to a number of assumptions, risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the forward-looking statements. The following important factors, in addition to those discussed in "Risk Factors," and other unforeseen events or circumstances, could affect our future results and could cause those results or other outcomes to differ materially from those expressed or implied in our forward-looking statements: general economic conditions; customer retention; competition; our ability to identify and integrate acquisitions; our ability to control costs; our ability to complete successfully our planned expansion; changes or consolidations within the commercial real estate industry; release of new and upgraded services by us or our competitors; data quality; development of our sales force; employee retention; technical problems with our services; managerial execution; changes in relationships with real estate brokers and other strategic partners; foreign currency fluctuations; legal and regulatory issues; changes in accounting policies or practices; and successful adoption of and training on our services.

Accordingly, you should not place undue reliance on forward-looking statements, which speak only as of the date of this Report. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this Report or to reflect the occurrence of unanticipated events.

Risk Factors

We have experienced operating losses and our future profitability is uncertain. Until the third quarter of 2003, we had not recorded an overall operating profit because the investment required for geographic expansion and new information services has caused our expenses to exceed our revenues. Our ability to continue to earn a profit will largely depend on our ability to manage our growth, including our expansion plans, and to generate revenues that exceed our expenses. In addition, our ability to continue to earn a profit, to increase revenues or to control costs could be affected by the factors set forth below. We may not be able to generate revenues or control expenses sufficient to earn a profit, to increase profits on a quarterly or annual basis, or to sustain or increase our future revenue growth and, as a result, the market price of our common stock may decline.

A downturn or consolidation in the commercial real estate industry may decrease customer demand for our services. The commercial real estate industry has begun to stabilize in recent months, as evidenced by improving, leasing activity, rental rates and absorption rates. However, a reversal of this trend or renewed downturn in the commercial real estate market may continue to affect our ability to generate revenues and may lead to more cancellations by our current or future customers, both of which could cause our revenues or our revenue growth rate to decline and reduce our profitability. A depressed commercial real estate market has a negative impact on our core customer base, which could decrease demand for our information services. Also, companies in this industry are consolidating, often in order to reduce expenses. Consolidation may lead to more cancellations of our information services by our customers, reduce the number of our existing clients, reduce the size of our target market or increase our clients' bargaining power, all of which could cause our revenues or our revenue growth rate to decline and reduce our profitability.

We may not be able to complete successfully our planned geographic expansion, which may negatively impact our business, results of operations and financial condition. Expanding into new markets imposes additional burdens on our research, systems development, sales, marketing and general managerial resources. In 2004, we expect to expand into 21 new U.S. markets and expand geographic coverage in certain of our existing markets. If we are unable to manage this expansion plan, our financial condition could be adversely affected. In addition, if we incur significant costs to expand into these new markets, or are not successful in marketing and selling our services in these markets, then it may have a material adverse effect on our financial condition by increasing our expenses without increasing our revenues. If we are unable to complete successfully our planned geographic expansion or if we are unable to manage this expansion successfully, it may adversely affect our profitability.

We may not be able to successfully introduce new or upgraded information services, which could decrease our revenues and our profitability. Our future business and financial success will depend on our ability to continue to introduce new and upgraded services into the marketplace. To be successful, we must adapt to rapid technological changes by continually enhancing our information services. Developing new services and upgrades to services imposes heavy burdens on our systems department, management and researchers. This process is costly, and we cannot assure you that we will be able to successfully develop and enhance our services. In addition, successfully launching and selling a new service puts pressure on our sales and marketing resources. If we are unable to develop new or upgraded services, then our customers may choose a competitive service over ours and our revenues may decline and our profitability may be reduced. In addition, if we incur significant costs in developing new or upgraded services, are not successful in marketing and selling these new services or upgrades, or our customers fail to accept these new services, it could have a material adverse effect on our results of operations by decreasing our revenues or our revenue growth rate and by reducing our profitability.

General economic conditions could increase our expenses and reduce our revenues. Our business and the commercial real estate industry are particularly affected by negative trends in the general economy. The success of our business depends on a number of factors relating to general global, national, regional and local economic conditions, including inflation, interest rates, perceived and actual economic conditions, taxation policies, availability of credit, employment levels, and wage and salary levels. The recent negative state of the economy, and the commercial real estate industry in particular, has had a negative impact on our business. Negative general economic conditions could adversely affect our business by reducing our revenues and profitability. Additionally, any war in which the United States is involved or any significant terrorist attack is likely to have a dampening effect on the economy in general which could negatively affect our financial performance and our stock price. In addition, a significant increase in inflation could increase our expenses, which may not be offset by increased revenues. If clients choose to cancel our information services as a result of economic conditions, and we do not acquire new clients, our revenues may decline and our financial position would be adversely affected.

If we are not able to successfully identify and integrate acquisitions, our business operations and financial condition could be adversely affected. We have expanded our markets and services in part through acquisitions of complementary businesses, services, databases and technologies, and expect to continue to do so in the future. Our strategy to acquire complementary companies or assets depends on our ability to identify, and the availability of, suitable acquisition candidates. In addition, acquisitions involve numerous risks, including managing the integration of personnel and products; managing geographically remote operations, such as Property Intelligence in the United Kingdom; the diversion of management's attention from other business concerns; the inherent risks in entering markets and sectors in which we have either limited or no direct experience; and the potential loss of key employees or clients of the acquired companies. We may not successfully integrate any acquired businesses or assets and may not achieve anticipated benefits of any acquisition. Future acquisitions that we may pursue could result in dilutive issuances of equity securities, the incurrence of debt, one-time write-offs of goodwill and substantial amortization expenses of other intangible assets.

Our stock price may be negatively affected by fluctuations in our operating results. Our operating results, revenues and expenses may fluctuate with general economic conditions and also for many other reasons, many of which are outside of our control, such as: cancellations or non-renewals of our services; competition; our ability to control expenses; loss of clients or revenues; changes or consolidation in the real estate industry; the timing and success of new service introductions and enhancements; successful execution of our expansion plan; the development of our sales force; managerial execution; data quality; employee retention; foreign currency fluctuations; our investments in geographic expansion; successful adoption of and training on the Company's services; the timing of investing the net proceeds from our offerings; acquisitions of other companies or assets; sales, brand enhancement and marketing promotional activities; client training and support activities; changes in client budgets; or our investments in other corporate resources. In addition, changes in accounting policies or practices may affect our level of GAAP net income, including without limitation, changes requiring us to expense stock options. Fluctuations in our operating results, revenues and expenses may cause the market price of our common stock to decline.

Our revenues and financial condition will be adversely affected if we are not able to attract and retain clients. Our success and revenues depend on attracting and retaining subscribers to our information services. Our subscription-based information services generate the largest portion of our revenues. However, we may be unable to attract new clients in planned expansion markets and our clients existing markets may decide not to add, not to renew or to cancel subscription services as a result of several factors, including without limitation: a decision that they have no need for our services; a decision to use alternative services; pricing and budgetary constraints; consolidation in the real estate industry; data quality; technical problems; or economic or competitive pressures. If clients decide not to renew or cancel their agreements, and we do not attract new clients, then our revenues or our revenue growth rate may decline.

If our operating costs are higher than we expect, our profitability may be reduced. Many of our expenses, particularly personnel costs and occupancy costs, are relatively fixed. As a result, we may not be able to adjust spending quickly enough to offset any unexpected revenue shortfall or increase in expenses. Additionally, we may experience higher than expected operating costs, including increased personnel costs, selling and marketing costs, investments in geographic expansion, acquisition costs, occupancy costs, communications costs, travel costs, software development costs, outside services costs and other costs. If operating costs exceed our expectations or cannot be adjusted accordingly, our profitability may be reduced and our results of operations and financial condition will be adversely affected.

Competition could render our services uncompetitive. The market for information systems and services in general is highly competitive and rapidly changing. Our existing competitors, or future competitors, may have greater name recognition, larger customer bases, better technology or data, lower prices, easier access to data, greater user traffic or greater financial, technical or marketing resources than we have. Our competitors may be able to undertake more effective marketing campaigns, obtain more data, adopt more aggressive pricing policies, make more attractive offers to potential employees, subscribers, distribution partners and content providers or may be able to respond more quickly to new or emerging technologies or changes in user requirements. Increased competition could result in lower revenues and higher expenses, which would reduce our profitability.

International expansion may result in new business risks which may reduce our profitability. Our international expansion could subject us to new business risks, including: adapting to the differing business practices and laws in foreign countries; difficulties in managing foreign operations; limited protection for intellectual property rights in some countries; difficulty in collecting accounts receivable and longer collection periods; costs of enforcing contractual obligations; impact of recessions in economies outside the United States; currency exchange rate fluctuations; and potentially adverse tax consequences. In addition, international expansion imposes additional burdens on our executive and administrative personnel, systems development, research and sales departments, and general managerial resources. If we are not able to manage our growth successfully, we may incur higher expenses and our profitability may be reduced. Finally, the investment required for international expansion could exceed the profit generated from such expansion, which would reduce our profitability and adversely affect our financial condition.

Fluctuating foreign currencies may negatively impact our business, results of operations and financial condition. As a result of the Property Intelligence acquisition, a portion of our business is denominated in the British Pound and as a result, fluctuations in foreign currencies may have an impact on our business, results of operations, and financial condition. Currencies may be affected by internal factors, and external developments in other countries, all of which can have an adverse impact on a country's currency. Currently, we do not have any hedging transactions to reduce our exposure to exchange rate fluctuations. We may seek to enter into hedging transactions in the future but we may be unable to enter into these transactions successfully, on acceptable terms or at all. We cannot predict whether we will incur foreign exchange losses in the future, and significant foreign exchange fluctuations resulting in a decline in the British Pound may decrease the value of our foreign assets, as well as decrease our revenues and earnings from our foreign subsidiaries.

If we are not able to obtain and maintain accurate, comprehensive or reliable data, we could experience reduced demand for our information services. Our success depends on our clients' confidence in the comprehensiveness, accuracy and reliability of the data we provide. The task of establishing and maintaining accurate and reliable data is challenging. If our data, including the data we obtain from third parties, is not current, accurate, comprehensive or reliable, we could experience reduced demand for our services or legal claims by our customers, which could result in lower revenues and higher expenses.

If we are unable to hire, retain and continue to develop our sales force, our revenues could be adversely affected. In order to support revenue growth, we need to continue to develop, train and retain our sales force. Our ability to build and develop a strong sales force may be affected by a number of factors, including: our ability to integrate and motivate sales personnel; our ability to effectively train our sales force; the ability of our sales force to sell an increased number of services; the length of time it takes new sales personnel to become productive; the competition we face from other companies in hiring and retaining sales personnel; and our ability to effectively manage a multi-location sales organization. If we are unable to hire, develop or retain the members of our sales force, or if our sales force is unproductive, our revenues could decline or cease to grow and our expenses could increase.

Temporary or permanent outages of our computers, software or telecommunications equipment could lead to reduced demand for our information services. Our operations depend on our ability to protect our database, computers and software, telecommunications equipment and facilities against damage from potential dangers such as fire, power loss, security breaches, computer viruses and telecommunications failures. Any temporary or permanent loss of one or more of these systems or facilities from an accident, equipment malfunction or some other cause could harm our business. If we experience a failure that prevents us from delivering our information services to clients, we could experience reduced demand for our information services.

Technical problems that affect our customers' use of or access to our services could lead to reduced demand for our information services. Our business increasingly depends upon the satisfactory performance, reliability and availability of our web site, the Internet and our service providers. Problems with our web site, the Internet or the services provided by our local exchange carriers or Internet service providers could result in slower connections for our customers or interfere with our customers' access to our information services. If we experience technical problems in distributing our services, we could experience reduced demand for our information services. In addition, the software underlying our services is complex and may contain undetected errors. Despite testing, we cannot be certain that errors will not be found in our software. Any errors could result in adverse publicity, impaired use of our services, loss of revenues, cost increases and legal claims by customers. All these factors could seriously damage our business, operating results and financial condition.

Our business depends on retaining and attracting highly capable management and operating personnel. Our success depends in large part on our ability to retain and attract management and operating personnel, including our President and Chief Executive Officer, Andrew Florance, our officers and other key employees. Our business requires highly skilled technical, sales, management, web-development, marketing and research personnel, who are in high demand and are often subject to competing offers. To retain and attract key personnel, we use various measures, including employment agreements, a stock incentive plan and incentive bonuses for key executive officers. These measures may not be enough to retain and attract the personnel we need or to offset the impact on our business of the loss of the services of Mr. Florance or other key officers or employees.

Litigation in which we become involved or newly-adopted laws and regulations may significantly increase our expenses. Currently and from time to time, we are involved in litigation incidental to the conduct of our business. We cannot assure you that we will have sufficient insurance to cover our pending claims or our future claims. Any lawsuits in which we are involved could cost us a significant amount of time and money. If any claims are determined against us, our profitability could be reduced and our financial position could be adversely affected. In addition, governments in the United States or abroad could adopt laws that could harm our business by for example, regulating the information we provide or regulating our transmissions over the Internet, or exposing our business to taxes in various jurisdictions. Compliance with any such laws could increase our costs or make our services less attractive.

If we are unable to enforce or defend our ownership and use of intellectual property, our business, competitive position and operating results could be harmed. The success of our business depends in large part on the intellectual property involved in our methodologies, database, services and software. We rely on a combination of trade secret, patent, copyright and other laws, nondisclosure and noncompetition provisions, license agreements and other contractual provisions and technical measures to protect our intellectual property rights. However, current law may not provide for adequate protection of our databases and the actual data. In addition, legal standards relating to the validity, enforceability and scope of protection of proprietary rights in Internet-related businesses are uncertain and evolving, and we cannot assure you of the future viability or value of any of our proprietary rights. Our business could be significantly harmed if we are not able to protect our content and our other intellectual property. The same would be true if a court found that our services infringe other persons' intellectual property rights. Any intellectual property lawsuits in which we are involved, either as a plaintiff or as a defendant, could cost us a significant amount of time and money and distract management's attention from operating our business. In addition, if we do not prevail on any intellectual property claims, this could result in a change to our methodology or information services and could reduce our profitability.

We may be subject to legal liability for displaying or distributing information. Because the content in our database is distributed to others, we may be subject to claims for defamation, negligence or copyright or trademark infringement or claims based on other theories. We could also be subject to claims based upon the content that is accessible from our web site through links to other web sites or information on our web site supplied by third parties. Even if these claims do not result in liability to us, we could incur significant costs in investigating and defending against any claims. Our potential liability for information distributed by us to others could require us to implement measures to reduce our exposure to such liability, which may require us to expend substantial resources and limit the attractiveness of our information services to users.

Market volatility may have an adverse effect on our stock price. The trading price of our common stock has fluctuated widely in the past, and we expect that it will continue to fluctuate in the future. The price could fluctuate widely based on numerous factors, including: quarter-to-quarter variations in our operating results; changes in analysts' estimates of our earnings; announcements by us or our competitors of technological innovations or new services; general conditions in the commercial real estate industry; developments or disputes concerning copyrights or proprietary rights; regulatory developments; and economic or other factors. In addition, in recent years, the stock market in general, and the shares of Internet-related and other technology companies in particular, have experienced extreme price fluctuations. This volatility has had a substantial effect on the market prices of securities issued by many companies for reasons unrelated to the operating performance of the specific companies.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We do not have material exposure to market risks associated with changes in interest rates related to cash equivalent securities held as of December 31, 2003.

We have a substantial amount of intangible assets. Although as of December 31, 2003 we believe our intangible assets will be recoverable, changes in the economy, the business in which we operate and our own relative performance could change the assumptions used to evaluate intangible asset recoverability. In the event that we determine that an asset has been impaired, we would recognize an impairment charge for the excess amount by which the carrying amount of the assets exceeds the fair value of the asset. We continue to monitor these assumptions and their effect on the estimated recoverability of our intangible assets.

On January 6, 2003, we acquired the share capital of London-based Property Intelligence. Property Intelligence is a leading provider of information services to the commercial real estate and related business community in the United Kingdom. Our functional currency for our operations in the United Kingdom is the local currency. As such, fluctuations in the British Pound may have an impact on our business, results of operations and financial condition. We may seek to enter hedging transactions in the future to reduce our exposure to exchange rate fluctuations, but we may be unable to enter into hedging transactions successfully or at all.

Item 8. Financial Statements and Supplementary Data

Financial Statements meeting the requirements of Regulation S-X are set forth beginning at page F-1.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of December 31, 2003, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective and were operating at the reasonable assurance level.

There have been no changes in our internal control over financial reporting during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information required by this Item is incorporated by reference to our Proxy Statement for our 2004 annual meeting of stockholders.

Item 11. Executive Compensation

The information required by this Item is incorporated by reference to our Proxy Statement for our 2004 annual meeting of stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated by reference to our Proxy Statement for our 2004 annual meeting of stockholders.

Item 13. Certain Relationships and Related Transactions

The information required by this Item is incorporated by reference to our Proxy Statement for our 2004 annual meeting of stockholders.

Item 14. Principal Accounting Fees and Services

The information required by this Item is incorporated by reference to our Proxy Statement for our 2004 annual meeting of stockholders.

PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) The following financial statements are filed as a part of this report: CoStar Group, Inc. Consolidated Financial Statements.

(a)(2) All schedules are omitted because they are not applicable or not required or because the required information is incorporated here by reference or included in the financial statements or related notes included elsewhere in this report.

(a)(3) The documents required to be filed as exhibits to this Report under Item 601 of Regulation S-K are listed in the Exhibit Index included elsewhere in this report, which list is incorporated herein by reference.

(b) On October 15, 2003, we “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, a report on Form 8-K relating to portions of the financial information for the CoStar Group, Inc. for the quarter ended September 30, 2003, as indicated in such Current Report (SEC File Number 000-24531).

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Bethesda, State of Maryland, on the 11th day of March 2004.

COSTAR GROUP, INC.

By: /s/ Andrew C. Florance
Andrew C. Florance
President and Chief Executive Officer

KNOW ALL PERSONS BY THESE PRESENTS, that each individual whose signature appears below constitutes and appoints Andrew C. Florance and Frank A. Carchedi, and each of them individually, as their true and lawful attorneys-in-fact and agents, with full power of substitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with all exhibits thereto and to all documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, herein by ratifying and confirming all that said attorneys-in-fact and agents or any of them, or his or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Act of 1934, as amended, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	**Capacity**	**Date**
/s/ Michael R. Klein Michael R. Klein	Chairman of the Board	March 10, 2004
/s/ Andrew C. Florance Andrew C. Florance	Chief Executive Officer and President and a Director (Principal Executive Officer)	March 11, 2004
/s/ Frank A. Carchedi Frank A. Carchedi	Chief Financial Officer (Chief Financial and Accounting Officer)	March 11, 2004
/s/ David Bonderman David Bonderman	Director	March 4, 2004
/s/ Warren H. Haber Warren H. Haber	Director	March 8, 2004
/s/ Josiah O. Low, III Josiah O. Low, III	Director	March 8, 2004
/s/ Christopher Nassetta Christopher Nassetta	Director	March 3, 2004

INDEX TO EXHIBITS

Exhibit No.	Description
2.1	Offer Document by CoStar Limited for the share capital of Property Intelligence plc (Incorporated by reference to Exhibit 2.1 to Amendment No. 2 to the Registration Statement on Form S-3 of the Registrant (Reg. No. 333-106769) filed with the Commission on August 14, 2003).
3.1	Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to Amendment No. 4 to the Registration Statement on Form S-1 of the Registrant (Reg. No. 333-47953) filed with the Commission on June 30, 1998 (the "1998 Form S-1")
3.2	Certificate of Amendment of Restate Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 to the Registrant's Report on Form 10-Q dated June 30, 1999).
3.3	Amended and Restated By-Laws (Incorporated by reference to Exhibit 3.2 to the 1998 Form S-1).
4.1	Specimen Common Stock Certificate (Incorporated by reference to Exhibit 4.1 to the Registrant's Report on Form 10-K for the year ended December 31, 1999 (the "1999 10-K")).
*10.1	CoStar Group, Inc. 1998 Stock Incentive Plan, as amended (Incorporated by reference to Exhibit 10.1 to the Registrant's Report on Form 10-Q dated June 30, 2002).
*10.2	Employment Agreement for Andrew C. Florance (Incorporated by reference to Exhibit 10.2 to the 1998 Form S-1).
*10.3	Employment Agreement for Frank A. Carchedi (Incorporated by reference to Exhibit 10.3 to the 1998 Form S-1).
*10.4	Employment Agreement for David M. Schaffel (Incorporated by reference to Exhibit 10.4 to the 1998 Form S-1).
*10.5	Employment Terms for Craig Farrington (Incorporated by reference to Exhibit 10.7 to the Registrant's Report on Form 10-K for the year ended December 31, 2000).
*10.6	Employment Terms for Michael Arabe (Incorporated by reference to Exhibit 10.7 to the Registrant's report on Form 10-K for the year ended December 31, 2002).
10.7	Office Lease, dated August 12, 1999, between CoStar Realty Information, Inc. and Newlands Building Ventures, LLC (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-Q dated September 30, 1999).
10.8	Office Sublease, dated June 14, 2002, between CoStar Realty Information, Inc., CoStar Group, Inc. and Gateway, Inc. (Incorporated by reference to Exhibit 10.2 to the Registrant's Report on Form 10-Q dated June 30, 2002).
21.1	Subsidiaries of the Registrant (filed herewith).
23.1	Consent of Independent Auditors (filed herewith).
24.1	Powers of Attorney (Included in the Signature Pages to the Report).
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Management Contract or Compensatory Plan or Arrangement.

COSTAR GROUP, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders
CoStar Group, Inc.

We have audited the accompanying consolidated balance sheets of CoStar Group, Inc. as of December 31, 2002 and 2003, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CoStar Group, Inc. at December 31, 2002 and 2003, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

As discussed in the notes to the consolidated financial statements, in 2002 the Company adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets".

/s/ Ernst & Young LLP

McLean, Virginia
February 13, 2004

COSTAR GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Year Ended December 31,		
	2001	**2002**	**2003**
Revenues	$ 72,513	$ 79,363	$ 95,105
Cost of revenues	30,316	28,012	30,742
Gross margin	42,197	51,351	64,363
Operating expenses:			
Selling and marketing	23,502	23,158	26,537
Software development	5,137	5,524	6,886
General and administrative	28,438	24,612	26,451
Purchase amortization	7,846	3,600	4,487
	64,923	56,894	64,361
Income (loss) from operations	(22,726)	(5,543)	2
Other income (expense):			
Loss on disposal of assets	(22)	—	—
Interest expense	(18)	(4)	—
Interest income	1,692	767	381
Other expense	(74)	(4)	(1)
Income (loss) before income taxes	(21,148)	(4,784)	382
Income tax expense (benefit)	(987)	—	282
Net income (loss)	$ (20,161)	$ (4,784)	$ 100
Net income (loss) per share — basic	$ (1.29)	$ (0.30)	$ 0.01
Net income (loss) per share — diluted	$ (1.29)	$ (0.30)	$ 0.01
Weighted average outstanding shares — basic	15,636	15,759	16,202
Weighted average outstanding shares — diluted	15,636	15,759	16,674

See accompanying notes.

COSTAR GROUP, INC.

CONSOLIDATED BALANCE SHEETS
(in thousands except per share data)

	December 31, 2002	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 25,546	$ 35,643
Cash held for acquisition	16,386	—
Short-term investments	1,598	61,806
Accounts receivable, less allowance for doubtful accounts of approximately $2,452 and $1,759 as of December 31, 2002 and 2003	6,786	4,308
Prepaid expenses and other current assets	1,567	1,981
Total current assets	51,883	103,738
Property and equipment, net	11,048	10,254
Goodwill, net	26,177	37,351
Intangibles and other assets, net	29,527	31,590
Deposits	272	967
Total assets	$ 118,907	$ 183,900
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,596	$ 1,235
Accrued wages and commissions	4,079	3,613
Accrued expenses	4,449	4,797
Deferred revenue	4,766	5,886
Total current liabilities	14,890	15,531
Stockholders' equity:		
Preferred stock, $0.01 par value; 2,000 shares authorized; none outstanding	—	—
Common stock, $0.01 par value; 30,000 shares authorized; 15,810 and 17,877 issued and outstanding as of December 31, 2002 and 2003	158	179
Additional paid-in capital	205,348	267,183
Accumulated other comprehensive income	—	2,396
Accumulated deficit	(101,489)	(101,389)
Total stockholders' equity	104,017	168,369
Total liabilities and stockholders' equity	$ 118,907	$ 183,900

See accompanying notes.

COSTAR GROUP, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Comprehensive Income (Loss)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders' Equity
Balance at December 31, 2000		15,545	$ 155	$ 202,763	$ —	$ (76,544)	$ 126,374
Net loss	(20,161)	—	—	—	—	(20,161)	(20,161)
Comprehensive loss	$ (20,161)						
Exercise of stock options		168	2	1,715	—	—	1,717
Restricted stock grants issued		5	—	89	—	—	89
Balance at December 31, 2001		15,718	157	204,567	—	(96,705)	108,019
Net loss	(4,784)	—	—	—	—	(4,784)	(4,784)
Comprehensive loss	$ (4,784)						
Exercise of stock options		88	1	695	—	—	696
Stock issued for acquisitions		5	—	99	—	—	99
Restricted stock grants retired		(1)	—	(13)	—	—	(13)
Balance at December 31, 2002		15,810	158	205,348	—	(101,489)	104,017
Net income	100	—	—	—	—	100	100
Foreign currency translation adjustment	2,419	—	—	—	2,419	—	2,419
Net unrealized loss on short-term investments	(23)	—	—	—	(23)	—	(23)
Comprehensive income	$ 2,496						
Exercise of stock options		395	4	8,257	—	—	8,261
Stock issued for acquisitions		5	—	97	—	—	97
Stock issued for follow-on public offering, net of offering costs		1,667	17	53,481	—	—	53,498
Balance at December 31, 2003		17,877	$ 179	$ 267,183	$ 2,396	$ (101,389)	$ 168,369

See accompanying notes.

COSTAR GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	2001	**2002**	**2003**
Operating activities:			
Net income (loss)	$ (20,161)	$ (4,784)	$ 100
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Depreciation	4,915	4,179	4,960
Amortization	14,334	7,608	8,206
Loss on disposal of assets	22	—	—
Income tax benefit	(987)	—	—
Provision for losses on accounts receivable	2,453	2,228	2,078
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(2,288)	(3,001)	885
Prepaid expenses and other current assets	(95)	(610)	659
Deposits	142	72	(631)
Accounts payable and accrued expenses	(2,466)	(336)	(2,403)
Deferred revenue	(417)	218	(304)
Net cash (used in) provided by operating activities	(4,548)	5,574	13,550
Investing activities:			
Purchases and sales of short-term investments	(8,080)	9,658	(60,231)
Purchases of property and equipment	(2,098)	(4,016)	(3,880)
Other assets	(170)	(421)	(377)
Cash held for acquisition	—	(16,386)	16,386
Acquisitions, net of acquired cash	—	(305)	(17,419)
Net cash used in investing activities	(10,348)	(11,470)	(65,521)
Financing activities:			
Exercise of stock options	1,717	696	8,261
Issuance of common stock, net	—	—	53,498
Net cash provided by financing activities	1,717	696	61,759
Effect of foreign currency exchange rates on cash and cash equivalents	—	—	309
Net (decrease) increase in cash and cash equivalents	(13,179)	(5,200)	10,097
Cash and cash equivalents at beginning of year	43,925	30,746	25,546
Cash and cash equivalents at end of year	$ 30,746	$ 25,546	$ 35,643

See accompanying notes.

COSTAR GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION

CoStar Group, Inc. (the "Company") has created a comprehensive, proprietary database of commercial real estate information for metropolitan areas throughout the United States. Based on its unique database, the Company provides information services to the commercial real estate and related business community in the United States and the United Kingdom and operates within one business segment. The information services are typically distributed to its clients under subscription-based license agreements which have a minimum term of one year and renew automatically.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue Recognition

The Company primarily derives revenues from providing access to its proprietary database of commercial real estate information. The Company generally charges a fixed monthly amount for its subscription-based services. Subscription contract rates are based on the number of sites, number of users, organization size, the client's business focus and the number of services to which a client subscribes. Subscription-based license agreements typically have a minimum term of one year and renew automatically.

Revenues from subscription-based services are recognized on a straight-line basis over the term of the agreement. Deferred revenue results from advance cash receipts from customers or amounts billed to customers from the sales of subscription licenses and is recognized over the term of the licenses.

Cost of Revenues

Cost of revenues principally consists of salaries and related expenses for the Company's researchers who collect and analyze the commercial real estate data that is the basis for the Company's information services. Additionally, cost of revenues includes the cost of data from third-party data sources, which is expensed as incurred, and the amortization of database technology.

Significant Customers

No single customer accounted for more than 5% of the Company's revenues for the years ended December 31, 2001, 2002 and 2003.

Foreign Currency Translation

The Company's functional currency in its foreign location is the local currency. Assets and liabilities are translated into U.S. dollars as of the balance sheet date. Revenue, expenses, gains and losses are translated at the average exchange rates in effect during each period. Gains and losses resulting from translation are included in

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (Continued)

Foreign Currency Translation — (Continued)

accumulated other comprehensive income (loss). Net gains or losses resulting from foreign currency exchange transactions are included in the consolidated statement of operations. The Company had an increase in comprehensive income (loss) of approximately $2.4 million from the translation of its foreign subsidiary's assets and liabilities into U.S. dollars for the year ended December 31, 2003. There were no material gains or losses from foreign currency exchange transactions for the year ended December 31, 2003.

Comprehensive Income (Loss)

For the years ended December 31, 2001, 2002 and 2003, total comprehensive income (loss) was approximately $(20.2) million, $(4.8) million and $2.5 million, respectively. As of December 31, 2003, accumulated other comprehensive income (loss) included a gain from foreign currency translation adjustments of approximately $2.4 million and an unrealized loss on short-term investments of approximately $(23,000).

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expense was $268,000, $165,000 and $354,000 for the years ended December 31, 2001, 2002, and 2003, respectively.

Income Taxes

The Company provides for income taxes under the provisions of Statement of Financial Accounting Standards No. 109 ("FAS 109"). Deferred income taxes result from temporary differences between the tax basis of assets and liabilities and the basis reported in the Company's consolidated financial statements. Deferred tax liabilities and assets are determined based on the difference between financial statement and tax basis of assets and liabilities using enacted rates expected to be in effect during the year in which the differences reverse. Valuation allowances are provided against assets, including net operating losses, if it is anticipated that some or all of the asset may not be realized through future taxable earnings or implementation of tax planning strategies.

Net Income (Loss) Per Share

Net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period on a basic and diluted basis. The Company's potentially dilutive securities include stock options. Diluted net income (loss) per share considers the impact of potentially dilutive securities except in periods in which there is a net loss as the inclusion of the potential common shares would have an anti-dilutive effect.

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with APB No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Under APB 25, compensation expense is based on the difference, if any, on the date of grant between the fair value of the Company's common stock and the exercise price of the option and is recognized ratably over the vesting period of the option. Stock-based compensation related to options granted to non-employees is accounted for using the fair value method in accordance with the Statement of Financial Accounting Standard No. 123 "Accounting for Stock-Based Compensation" ("FAS 123"). The following table

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (Continued)

Stock-Based Compensation — (Continued)

illustrates the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of FAS 123 to stock-based employee compensation (in thousands, except per share amounts):

	Year Ended December 31,		
	2001	2002	2003
Net income (loss), as reported	$ (20,161)	$ (4,784)	$ 100
Add: stock-based employee compensation expense included in reported net income (loss)	—	—	—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(7,759)	(6,987)	(4,193)
Pro forma net income (loss)	$ (27,920)	$ (11,771)	$ (4,093)
Net income (loss) per share:			
Basic — as reported	$ (1.29)	$ (0.30)	$ 0.01
Basic — pro forma	$ (1.79)	$ (0.75)	$ (0.25)
Diluted — as reported	$ (1.29)	$ (0.30)	$ 0.01
Diluted — pro forma	$ (1.79)	$ (0.75)	$ (0.25)

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of money market fund investments and United States Government Securities, substantially all of which are held with two institutions. As of December 31, 2002 and 2003 cash of $1,053,000 was held in accounts to support letters of credit.

Short-Term Investments

The Company accounts for short-term investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities." The Company determines the appropriate classification of investments at the time of purchase and reevaluates such designation as of each balance sheet date. The Company considers all of its investments to be available-for-sale. Investments consist of commercial paper, government/federal notes and bonds and corporate obligations with maturities greater than 90 days at the time of purchase. Investments are carried at fair market value.

Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income in stockholders' equity until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis. A decline in market value of any available-for-sale security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Dividend and interest income are recognized when earned.

During the year ended December 31, 2003, the Company recognized net unrealized losses on short-term investments of approximately $23,000. Cost approximated fair market value for these securities as of December 31, 2002.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (Continued)

Concentration of Credit Risk and Financial Instruments

The Company performs ongoing credit evaluations of its customers' financial condition and generally does not require that its customers' obligations to the Company be secured. The Company maintains reserves for credit losses, and such losses have been within management's expectations. The risk of nonpayment of the Company's accounts receivable is mitigated by the large size and widespread nature of the Company's customer base and lack of dependence on individual customers. The carrying amount of the accounts receivable approximates their net realizable value. The carrying value of the Company's financial instruments including cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and accrued expenses approximates fair value.

Property and Equipment

Property and equipment are stated at cost. All repairs and maintenance costs are expensed as incurred. Depreciation and amortization are calculated on the straight-line method over the following estimated useful lives of the assets:

Leasehold improvements	Shorter of lease term or useful life
Furniture and office equipment	Seven years
Research vehicles	Three years
Computer hardware and software	Two to five years

Internal use software costs are capitalized in accordance with Statement of Position No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). Qualifying costs incurred during the application development stage, which consist primarily of outside services and purchased software license costs, are capitalized and amortized over the estimated useful life of the asset. All other costs are expensed as incurred.

Capitalized Product Development Costs

Initial costs to develop and produce the Company's database and software products, including direct labor, contractors and applicable overhead are capitalized from the time technological feasibility is determined until initial product release. Prior to technological feasibility, such costs are classified as software development and expensed as incurred. Ongoing significant enhancements of the products are capitalized subsequent to initial product release. Amortization of capitalized costs is based on the greater of the amount computed using (a) the ratio of current gross revenues to the sum of current and anticipated gross revenues, or (b) the straight-line method over the remaining estimated economic life of the product, typically five years after initial product release. Included in amortization expense is approximately $239,000, $260,000 and $193,000 of expense related to the capitalized product development costs for the years ended December 31, 2001, 2002 and 2003, respectively.

Goodwill, Intangibles and Other Assets

Goodwill represents the excess of costs over the fair value of assets of businesses acquired. Goodwill and intangible assets subject to amortization that arose from acquisitions prior to July 1, 2001, have been amortized on a straight-line basis over their estimated useful lives in accordance with Accounting Principles Board Opinion No. 17, "Intangible Assets". The Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), as of January 1, 2002. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 also requires that intangible assets with estimable useful lives that arose from acquisitions on or after July 1, 2001 be amortized over their respective estimated useful lives using a method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, and reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for Impairment

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES — (Continued)

Goodwill, Intangibles and Other Assets — (Continued)

or Disposal of Long-Lived Assets". In connection with the adoption of SFAS 142, the Company performed the transitional impairment test during the second quarter of 2002 and concluded that goodwill was not impaired.

As of January 1, 2002, the Company had unamortized goodwill of approximately $25.7 million. Prior to January 1, 2002, goodwill was amortized on a straight-line basis over its expected economic life, generally two to ten years, and assessed for recoverability by determining whether the amortization of the goodwill balance over its remaining life could be recovered through the undiscounted future operating cash flows of the acquired operation. In the aggregate, amortization of goodwill in 2001, prior to the adoption of SFAS 142, was approximately $4.2 million.

Acquired technology, customer base and tradename are related to the Company's acquisitions (See Notes 3 and 5). Acquired technology and tradename are amortized on a straight-line basis over periods ranging from two to ten years. The acquired intangible asset characterized as customer base consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships. Customer bases that arose from acquisitions prior to July 1, 2001 are amortized on a straight-line basis principally over a period of ten years. Customer bases that arose from acquisitions on or after July 1, 2001 are amortized on a 125% declining balance method over ten years. The cost of photography is amortized on a straight-line basis over five years.

Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 144, long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset or asset group. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.

New Accounting Pronouncements

Effective January 1, 2003, the Company adopted Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"). SFAS 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of commitment to an exit or disposal plan. SFAS 146 replaces previous accounting guidance provided by Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)," and is effective for the Company for exit or disposal activities initiated after December 31, 2002. Adoption of this statement had no material impact on the Company's consolidated financial position, consolidated results of operations, or liquidity.

3. ACQUISITIONS

On November 9, 2000, the Company completed the acquisition of First Image, the owner of the Metropolis software system, a single interface that combines commercial real estate data from multiple information providers. The Company acquired all of the outstanding capital stock of First Image for approximately $665,000 in cash and 9,424 shares of our common stock. The transaction was accounted for as a purchase and the initial consideration was valued for accounting purposes at approximately $950,000 including acquisition expenses. In addition, the acquisition agreement provided for approximately $950,000 of additional consideration (in a combination of cash and stock) to be paid by CoStar upon the achievement of certain operating goals by the sole stockholder of First Image. On June 7, 2002, in consideration of the achievement of one of the operating goals, the Company issued additional consideration valued at approximately $432,000 consisting of a cash payment of approximately $333,000 and 4,712 shares of common stock. On February 28, 2003, the second and final earn-out condition was satisfied. As a result, the Company recorded additional purchase consideration valued at approximately $430,000, consisting of a cash payment of $333,000 and the issuance of 4,712 shares of common stock.

On September 19, 2002, the Company acquired certain assets of Portland-based commercial real estate information provider, REAL-NET, in a purchase business combination for $305,000 in cash. The transaction was accounted for as a purchase and the consideration was valued for accounting purposes at approximately $320,000 including acquisition expenses. The purchase price was allocated primarily to acquired database technology and customer base. The acquired database technology is being amortized on a straight-line basis over 5 years. The customer base, which consists of one distinct intangible asset composed of acquired customer contracts and related customer relationships, is being amortized on a 125% declining balance method over a period of five years.

On January 6, 2003, the Company acquired the share capital of London-based Property Intelligence plc (“Property Intelligence”) for the U.S. dollar equivalent of approximately $17.4 million, net of cash acquired of approximately $1.4 million. The acquisition has been accounted for using purchase accounting and the purchase price was allocated as follows (in thousands):

	Value
Working capital and other tangible assets	$ 103
Acquired database technology	1,186
Customer base	8,000
Goodwill	9,555
	$ 18,844

The acquired database technology is being amortized on a straight-line basis over 5 years. The customer base, which consists of one distinct intangible asset composed of acquired customer contracts and the related customer relationships, is being amortized on a 125% declining balance method over 10 years. Goodwill will not be amortized, but is subject to annual impairment tests. The Company is in the process of obtaining additional information regarding the income tax attributes and deferred taxes related to Property Intelligence to complete the purchase price allocation. The results of operations of Property Intelligence have been consolidated with those of the Company since the date of acquisition. The operating results of Property Intelligence are not considered material to the consolidated financial statements of the Company, and accordingly, pro forma financial information has not been presented for this acquisition. The Company generated 92% and 8% of its total revenues in the United States and the United Kingdom, respectively, for the year ended December 31, 2003. In addition, 73% and 27% of the Company’s total long-lived assets, which are comprised of property and equipment, goodwill and intangibles and other assets, were located in the United States and the United Kingdom, respectively, as of December 31, 2003.

The operations of all acquired businesses were included in the Company’s statements of operations after the respective date of acquisitions. Except for the portion of the purchase price of acquisitions acquired with cash, these transactions have been excluded from the statements of cash flows.

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

	December 31, 2002	December 31, 2003
Leasehold improvements	$ 3,239	$ 3,360
Furniture, office equipment and research vehicles	7,351	7,116
Computer hardware and software	15,968	18,480
	26,558	28,956
Accumulated depreciation and amortization	(15,510)	(18,702)
Property and equipment, net	$ 11,048	$ 10,254

5. GOODWILL

Goodwill consists of the following (in thousands):

	December 31, 2002	December 31, 2003
Goodwill	$ 37,400	$ 48,574
Accumulated amortization	(11,223)	(11,223)
Goodwill, net	$ 26,177	$ 37,351

On January 1, 2002, the Company adopted the nonamortization approach under SFAS No. 142 for goodwill. The results for prior years have not been restated. A reconciliation of previously reported net loss and net loss per share in 2001 to the amounts adjusted for exclusion of goodwill amortization, including a comparison of net income (loss) and net income (loss) per share in 2002 and 2003, is as follows (in thousands except per share data):

	Year Ended December 31, 2001	2002	2003
Net income (loss), as reported	$ (20,161)	$ (4,784)	$ 100
Goodwill amortization	4,230	—	—
Adjusted net income (loss)	$ (15,931)	$ (4,784)	$ 100
Basic and diluted net income (loss) per share, as reported	$ (1.29)	$ (0.30)	$ 0.01
Goodwill amortization	0.27	0.00	0.00
Adjusted basic and diluted net income (loss) per share	$ (1.02)	$ (0.30)	$ 0.01
Weighted average outstanding shares — basic	15,636	15,759	16,202
Weighted average outstanding share s— diluted	15,636	15,759	16,674

During the fourth quarters of 2002 and 2003, the Company completed the annual impairment test of goodwill and concluded that goodwill was not impaired.

6. INTANGIBLES AND OTHER ASSETS

Intangibles and other assets consists of the following (dollars in thousands):

	December 31, 2002	December 31, 2003	Weighted-Average Amortization Period (in years)
Capitalized product development costs	$ 1,795	$ 1,795	5
Accumulated amortization	(1,433)	(1,626)	
Capitalized product development costs, net	362	169	
Building photography	4,731	4,777	5
Accumulated amortization	(3,305)	(4,048)	
Building photography, net	1,426	729	
Acquired database technology	18,104	19,438	4
Accumulated amortization	(13,603)	(16,245)	
Acquired database technology, net	4,501	3,193	
Customer base	32,111	41,107	10
Accumulated amortization	(11,860)	(16,175)	
Customer base, net	20,251	24,932	
Tradename	4,198	4,198	10
Accumulated amortization	(1,211)	(1,631)	
Tradename, net	2,987	2,567	
Intangibles and other assets, net	$ 29,527	$ 31,590	

Amortization expense for intangibles and other assets was approximately $10.1 million, $7.6 million and $8.3 million for the years ended December 31, 2001, 2002 and 2003, respectively.

In the aggregate, amortization for intangibles and other assets for future periods is expected to be approximately $7.3 million, $5.5 million, $5.4 million, $5.0 million and $4.5 million for the years ending December 31, 2004, 2005, 2006, 2007 and 2008, respectively.

7. INCOME TAXES

The components of the provision (benefit) for income taxes attributable to operations consist of the following (in thousands):

	Year Ended December 31,		
	2001	2002	2003
Current:			
Federal	$ —	$ —	$ 77
State	—	—	205
Foreign	—	—	—
Total current	—	—	282
Deferred:			
Federal	(869)	—	—
State	(118)	—	—
Foreign	—	—	—
Total deferred	(987)	—	—
Total (benefit) provision for income taxes	$ (987)	$ —	$ 282

The components of deferred tax assets and liabilities consists of the following (in thousands):

	December 31,	
	2002	2003
Deferred tax assets:		
Reserve for bad debts	$ 734	$ 575
Accrued compensation	354	412
Net operating losses	32,670	31,234
Other liabilities	1,128	1,483
Total deferred tax assets	34,886	33,704
Deferred tax liabilities:		
Depreciation	(915)	(482)
Product development costs	(139)	(65)
Identified intangibles associated with purchase accounting	(6,767)	(5,048)
Total deferred tax liabilities	(7,821)	(5,595)
Net deferred tax asset	27,065	28,109
Valuation allowance	(27,065)	(28,109)
Net deferred taxes	$ —	$ —

7. INCOME TAXES — (Continued)

A valuation allowance has been established against the related net deferred tax assets due to the uncertainty of realization. The Company's change in valuation allowance was approximately $6.5 million and $1.0 million during the years ended December 31, 2002 and 2003, respectively. For the year ended December 31, 2003, the Company had income of approximately $2.8 million subject to applicable U.S. federal and state income tax laws and a loss of approximately $2.4 million subject to applicable U.K. tax laws.

The Company's provision for income taxes resulted in effective tax rates that varied from the statutory federal income tax rate as follows (in thousands):

	Year Ended December 31,		
	2001	2002	2003
Expected federal income tax (benefit) provision at 34%	$ (7,191)	$ (1,626)	$ 130
State income taxes, net of federal benefit	(951)	(253)	304
Foreign income taxes, net effect	—	—	98
Increase (decrease) in valuation allowance	6,965	2,111	(678)
Expenses not deductible for tax purposes	190	(232)	428
Deferred income tax expense (benefit)	$ (987)	$ —	$ 282

The Company paid approximately $0, $0 and $184,000 in income taxes for the years ended December 31, 2001, 2002 and 2003, respectively.

At December 31, 2003, the Company had net operating loss carryforwards for federal income tax purposes of approximately $79.5 million, which expire, if unused, from the year 2008 through the year 2023. The tax benefit of approximately $16.0 million of net operating losses related to stock options will be credited to equity when the benefit of these losses is realized through utilization of the net operating loss carryforwards. During 2000, the Company acquired a company that had net operating losses of approximately $19.4 million, which expire, if unused, through the year 2019. The use of these acquired net operating losses is subject to limitations imposed by the Internal Revenue Code. The Company also has alternative minimum tax credit carryforwards of approximately $78,000.

During 1999 and 2000, the Company made acquisitions, which were reported using the purchase method of accounting. These acquisitions included identified intangible assets, which in accordance with FAS 109, required deferred taxes and related goodwill to be recorded. Additionally, net operating losses from the acquired companies and the net operating losses from CoStar prior to the acquisition, totaling approximately $39.6 million, were valued in connection with the acquisition. The reversal of these deferred taxes in future periods may result in additions to the valuation allowance and the recording of additional tax expense in accordance with the provisions of FAS 109, requiring evaluation regarding future realization.

8. COMMITMENTS AND CONTINGENCIES

The Company leases office facilities and office equipment under various noncancelable operating leases. The leases contain various renewal options. Rent expense for the years ended December 31, 2001, 2002 and 2003 was approximately $5.3 million, $5.5 million and $5.7 million, respectively.

Future minimum lease payments as of December 31, 2003 are as follows (in thousands):

2004	$ 5,007
2005	5,278
2006	5,206
2007	4,551
2008	3,118
2009 and thereafter	3,147
	$ 26,307

Currently, and from time to time, the Company is involved in litigation incidental to the conduct of its business. The Company is not a party to any lawsuit or proceeding that, in the opinion of management, is likely to have a material adverse effect on its financial position or results of operations.

9. STOCKHOLDERS' EQUITY

Preferred Stock

The Company has 2,000,000 shares of preferred stock, $0.01 par value, authorized for issuance. The preferred stock may be issued from time to time by the Board of Directors as shares of one or more classes or series.

Common Stock

The Company has 30,000,000 shares of common stock, $0.01 par value, authorized for issuance. Dividends may be declared and paid on the common stock, subject in all cases to the rights and preferences of the holders of preferred stock and authorization by the Board of Directors. In the event of liquidation or winding up of the Company and after the payment of all preferential amounts required to be paid to the holders of any series of preferred stock, any remaining funds shall be distributed among the holders of the issued and outstanding common stock.

During November 2003, the Company completed a follow-on public offering of 1,667,500 shares of common stock (including the over-allotment option) (the "Follow-On Offering") for $34.25 per share. Total proceeds of the Follow-On Offering were approximately $53.5 million, after deducting approximately $3.2 million of underwriting discounts and commissions and offering expenses of approximately $446,000.

10. NET INCOME (LOSS) PER SHARE

The following table sets forth the calculation of basic and diluted net income (loss) per share (in thousands except per share amounts):

	Year Ended December 31,		
	2001	2002	2003
Numerator:			
Net income (loss)	$ (20,161)	$ (4,784)	$ 100
Denominator:			
Denominator for basic net income (loss) per share — weighted-average outstanding shares	15,636	15,759	16,202
Effect of dilutive securities:			
Stock options and warrants	—	—	472
Denominator for diluted net income (loss) per share — weighted-average outstanding shares	15,636	15,759	16,674
Net income (loss) per share — basic	$ (1.29)	$ (0.30)	$ 0.01
Net income (loss) per share — diluted	$ (1.29)	$ (0.30)	$ 0.01

Stock options and warrants to purchase approximately 1,840,000, 2,097,000 and 1,450,000 for the years ended December 2001, 2002 and 2003, respectively, were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of the stock options was greater than the average share price of the common shares and, therefore, the effect would have been antidilutive.

11. EMPLOYEE BENEFIT PLANS

Option Plan

In June 1998 the Company's Board of Directors adopted the Stock Incentive Plan (the "1998 Plan") prior to consummation of the IPO. The 1998 Plan provides for the grant of stock and stock options to officers, directors and employees of the Company and its subsidiaries. Options granted under the 1998 Plan may be incentive or non-qualified stock options. The exercise price for an incentive stock option may not be less than the fair market value of the Company's Common Stock on the date of grant. The vesting period of the options is determined by the Board of Directors and is generally four years. Upon the occurrence of a Change of Control, as defined in the 1998 Plan, all outstanding unexercisable options under the 1998 Plan immediately become exercisable. The Company has reserved 3,750,000 shares of common stock for issuance under the 1998 Plan. Unless terminated sooner by the Board of Directors, the 1998 Plan will terminate in 2008. Approximately 961,000 and 766,000 options were available for future grant under the 1998 Plan as of December 31, 2002 and 2003, respectively.

11. EMPLOYEE BENEFIT PLANS — (Continued)

Option Plan — (Continued)

Option activity was as follows:

	Number of Shares	Range of Exercise Price	Weighted-Average Exercise Price
Outstanding at December 31, 2000	1,716,957	$ 3.45 - $52.13	$22.05
Granted	544,550	$15.06 - $29.69	$20.88
Exercised	(167,739)	$ 3.45 - $24.88	$10.24
Canceled or expired	(254,049)	$ 7.44 - $44.75	$26.16
Outstanding at December 31, 2001	1,839,719	$ 3.45 - $52.13	$22.20
Granted	577,700	$16.20 - $26.25	$20.38
Exercised	(88,281)	$ 3.45 - $23.00	$20.75
Canceled or expired	(231,865)	$16.00 - $46.81	$24.98
Outstanding at December 31, 2002	2,097,273	$ 3.45 - $52.13	$22.00
Granted	476,500	$16.27 - $42.10	$26.09
Exercised	(397,834)	$ 8.50 - $38.46	$20.99
Canceled or expired	(254,613)	$16.00 - $52.13	$25.75
Outstanding at December 31, 2003	1,921,326	$ 3.45 - $52.13	$22.72
Exercisable at December 31, 2003	940,477	$ 3.45 - $52.13	$21.63
Exercisable at December 31, 2002	1,056,709	$ 3.45 - $52.13	$21.60
Exercisable at December 31, 2001	847,686	$ 3.45 - $52.13	$19.44

For the purposes of the disclosure required by FAS 123, the fair value of each option granted during the years ended December 2001, 2002 and 2003 was $18.16, $15.39 and $18.21, respectively. The Company estimated the fair value of each option granted on the date of grant using the Black-Scholes option-pricing model, using the assumptions noted in the following table:

	Year Ended December 31,		
	2001	2002	2003
Dividend yield	0%	0%	0%
Expected volatility	100%	75%	70%
Risk-free interest rate	5.5%	3.5%	3.0%
Expected life (in years)	5	5	5

Pro forma compensation expense for stock option plans would reduce our net income as described in the "Summary of Significant Accounting Policies" as required by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of FASB Statement No. 123".

11. EMPLOYEE BENEFIT PLANS — (Continued)

Option Plan — (Continued)

The following table summarizes information regarding options outstanding at December 31, 2003:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number of Shares	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$ 3.45 - $ 9.00	254,338	4.4	$ 6.26	254,338	$ 6.26
$15.75 - $18.06	296,925	7.8	17.87	88,875	17.97
$18.10 - $20.30	283,372	8.4	19.33	55,934	19.45
$20.32 - $23.88	205,401	7.9	22.60	63,935	22.86
$23.90 - $28.00	198,776	7.0	25.75	105,387	25.62
$28.15 - $29.63	129,000	9.4	28.26	10,500	29.24
$30.00 - $30.00	202,500	5.3	30.00	202,500	30.00
$30.06 - $30.75	203,138	8.3	30.32	55,323	30.75
$31.37 - $46.81	146,876	6.8	38.04	102,685	36.71
$52.13 - $53.13	1,000	6.2	52.13	1,000	52.13
	1,921,326	7.2	22.67	940,447	21.54

On September 28, 2001, the Company granted a total of 5,000 shares of restricted stock to the non-employee directors of the Company. The stock grants vest over a four-year period with 25% of the stock vesting on each anniversary of the grant date. The Company recorded $89,800 in deferred compensation expense during the year ended December 31, 2001 in connection with these stock grants. The deferred compensation is calculated at the fair value on the grant date and is being amortized over the vesting period of the restricted stock.

Employee 401(k) Plan

The Company maintains a 401(k) Plan (the “401(k)”) as a defined contribution retirement plan for all eligible employees. The 401(k) provides for tax deferred contributions of between l% and 100% of employees’ salaries, limited to a maximum annual amount as established by the Internal Revenue Service. The Company matched 100% in 2001, 2002 and 2003 of employee contributions up to a maximum of 6% of total compensation. Amounts contributed to the 401(k) by the Company to match employee contributions for the years ended December 31, 2001, 2002, and 2003 were approximately $1.2 million, $1.2 million and $1.4 million, respectively.

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SUPPLEMENT TO THE COSTAR GROUP 2003 ANNUAL REPORT

Reconciliation of Quarterly EBITDA with 2002-2003 Quarterly Net Income (Loss)

($'s in millions)

	2002				2003			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Net income (loss)	$ (1.6)	$ (1.3)	$ (1.1)	$ (0.8)	$ (0.8)	$ (0.4)	$ 0.3	$ 1.0
Purchase amortization	1.8	1.6	1.5	1.6	1.8	1.8	1.8	1.8
Depreciation and other amortization	1.3	1.3	1.3	1.3	1.5	1.6	1.5	1.5
Interest income, net	(0.2)	(0.2)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.2)
Income tax expense	-	-	-	-	-	-	0.2	0.1
EBITDA	$ 1.3	$ 1.4	$ 1.6	$ 2.0	$ 2.4	$ 2.9	$ 3.7	$ 4.2

Directors:

Michael R. Klein, Chairman of the Board, CoStar Group, Inc.; Partner, Wilmer Cutler Pickering LLP

Andrew C. Florance*, President & Chief Executive Officer, CoStar Group, Inc.

David Bonderman, Principal, Texas Pacific Group

Warren H. Haber, Chairman of the Board & Chief Executive Officer, Founders Equity Inc.

Josiah O. Low, III, Venture Partner, Catterton Partners IV, L.P.

Christopher J. Nassetta, President & Chief Executive Officer, Host Marriott Corporation

SHAREHOLDER INFORMATION:

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Symbol: CSGP, NASDAQ® Listed

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Officers:

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Jonathan Bray, Managing Director, Property Intelligence Limited

Frank A. Carchedi*, Chief Financial Officer & Treasurer

Craig S. Farrington*, Vice President, Research

Andrew C. Florance*, President & Chief Executive Officer

Carla J. Garrett, General Counsel & Secretary

Mark A. Klionsky, Senior Vice President, Marketing & Corporate Communications

David M. Schaffel*, Chief Information Officer

Dean L. Violagis, Vice President, Research

**Denotes CoStar Executive Officer*

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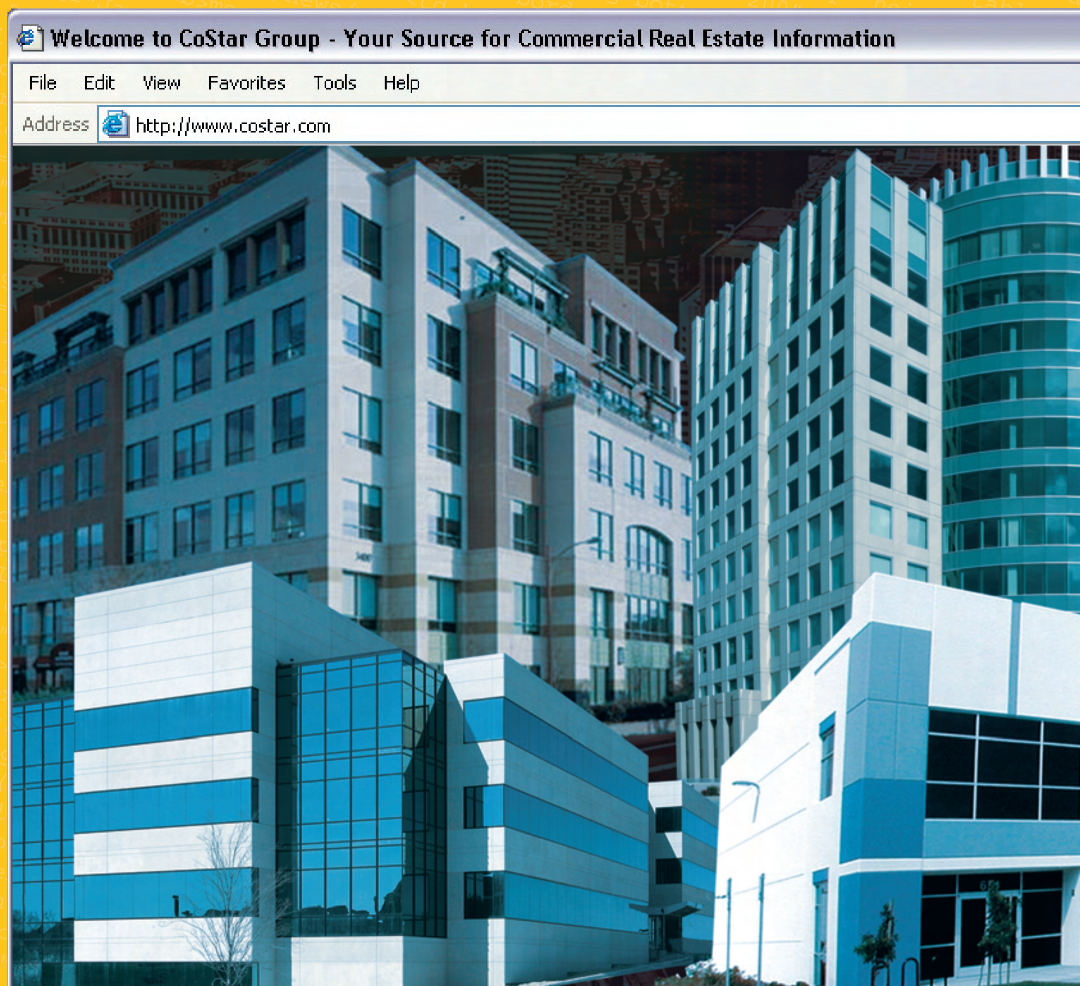
This report contains "forward-looking statements." Please review the section entitled "Risk Factors" in the enclosed Form 10-K for potential factors that could cause actual results to differ materially from these forward-looking statements. All forward-looking statements are based on information available to us on the date of this report, and we assume no obligation to update such statements.

CoStar Group
Real Estate Information



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