

QUINSTREET, INC  
Form 10-Q  
November 05, 2012  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2012**

or

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

**For the transition period from            to**

**Commission File No. 001-34628**

**QuinStreet, Inc.**

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

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

**77-0512121**  
(I.R.S. Employer  
Identification No.)

**950 Tower Lane, 6th Floor**

**Foster City, California**  
(Address of principal executive offices)

**94404**  
(Zip Code)

**650-578-7700**

**Registrant's telephone number, including area code**

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Number of shares of common stock outstanding as of October 31, 2012: 42,773,664

---

**Table of Contents**

**QUINSTREET, INC.**

**INDEX**

<b><u>PART I. FINANCIAL INFORMATION</u></b>	<b>3</b>
<b><u>Item 1. Financial Statements</u></b>	<b>3</b>
<b><u>Condensed Consolidated Balance Sheets at September 30, 2012 and June 30, 2012</u></b>	<b>3</b>
<b><u>Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2012 and 2011.</u></b>	<b>4</b>
<b><u>Condensed Consolidated Statements of Comprehensive (Loss) Income for the Three Months Ended September 30, 2012 and 2011</u></b>	<b>5</b>
<b><u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2012 and 2011.</u></b>	<b>6</b>
<b><u>Notes to Condensed Consolidated Financial Statements</u></b>	<b>7</b>
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	<b>21</b>
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	<b>31</b>
<b><u>Item 4. Controls and Procedures</u></b>	<b>31</b>
<b><u>PART II. OTHER INFORMATION</u></b>	<b>33</b>
<b><u>Item 1. Legal Proceedings</u></b>	<b>33</b>
<b><u>Item 1A. Risk Factors</u></b>	<b>33</b>
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	<b>52</b>
<b><u>Item 3. Defaults Upon Senior Securities</u></b>	<b>52</b>
<b><u>Item 4. Mine Safety Disclosures</u></b>	<b>52</b>
<b><u>Item 5. Other Information</u></b>	<b>52</b>
<b><u>Item 6. Exhibits</u></b>	<b>53</b>
<b><u>SIGNATURES</u></b>	<b>54</b>

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****QUINSTREET, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share data)****(Unaudited)**

	<b>September 30, 2012</b>	<b>June 30, 2012</b>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 64,448	\$ 68,531
Marketable securities	39,145	36,736
Accounts receivable, net	44,912	52,830
Deferred tax assets	7,662	7,665
Prepaid expenses and other assets	7,783	7,774
Total current assets	163,950	173,536
Property and equipment, net	8,430	8,755
Goodwill	242,955	243,049
Other intangible assets, net	65,645	72,444
Deferred tax assets, noncurrent	8,446	8,446
Other assets, noncurrent	878	930
Total assets	\$ 490,304	\$ 507,160
<b>Liabilities and Stockholders Equity</b>		
Current liabilities		
Accounts payable	\$ 20,074	22,870
Accrued liabilities	22,324	29,462
Deferred revenue	2,243	2,553
Debt	13,623	15,429
Total current liabilities	58,264	70,314
Debt, noncurrent	89,180	92,167
Other liabilities, noncurrent	7,001	6,322
Total liabilities	154,445	168,803
<b>Commitments and contingencies (See Note 8)</b>		
<b>Stockholders equity</b>		
Common stock: \$0.001 par value; 100,000,000 shares authorized; 42,762,966 and 43,350,831 shares issued, and 42,762,966 and 43,222,031 shares outstanding at September 30, 2012 and June 30, 2012, respectively	43	43
Additional paid-in capital	217,299	220,552
Treasury stock, at cost (0 and 128,800 shares at September 30, 2012 and June 30, 2012)		(1,178)
Accumulated other comprehensive loss	(1,726)	(1,439)
Retained earnings	120,243	120,379

Edgar Filing: QUINSTREET, INC - Form 10-Q

Total stockholders' equity	335,859	338,357
Total liabilities and stockholders' equity	\$ 490,304	\$ 507,160

See notes to condensed consolidated financial statements

**Table of Contents****QUINSTREET, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(Unaudited)**

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Net revenue	\$ 78,626	\$ 101,224
Cost of revenue <sup>(1)</sup>	65,190	75,748
Gross profit	13,436	25,476
Operating expenses: <sup>(1)</sup>		
Product development	4,893	6,074
Sales and marketing	3,691	4,034
General and administrative	3,926	5,217
Operating income	926	10,151
Interest income	28	38
Interest expense	(1,012)	(1,083)
Other income (expense), net	46	(31)
(Loss) income before income taxes	(12)	9,075
Provision for taxes	(125)	(3,581)
Net (loss) income	\$ (137)	\$ 5,494
Net (loss) income per share:		
Basic	\$ (0.00)	\$ 0.12
Diluted	\$ (0.00)	\$ 0.11
Weighted average shares used in computing net income per share:		
Basic	42,812	47,505
Diluted	43,320	48,975

<sup>(1)</sup> Cost of revenue and operating expenses include stock-based compensation expense as follows:

Cost of revenue	\$ 923	\$ 1,179
Product development	693	660
Sales and marketing	765	779
General and administrative	389	756

See notes to condensed consolidated financial statements

**Table of Contents****QUINSTREET, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME****(In thousands)****(Unaudited)**

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Net (loss) income	\$ (137)	\$ 5,494
Other comprehensive income (loss)		
Unrealized gain on investments	4	4
Foreign currency translation adjustment	253	25
Interest rate swap		
Change in unrealized gains	(398)	
Less: reclassification adjustment for gains included in net income	(146)	
Net change	(544)	
Other comprehensive (loss) income	(287)	29
Comprehensive (loss) income	\$ (424)	\$ 5,523

**Table of Contents****QUINSTREET, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Cash Flows from Operating Activities</b>		
Net (loss) income	\$ (137)	\$ 5,494
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,279	7,108
Provision for sales returns and doubtful accounts receivable	(316)	36
Stock-based compensation	2,770	3,374
Excess tax benefits from stock-based compensation	(24)	(35)
Other non-cash adjustments, net	75	243
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	8,323	(6,087)
Prepaid expenses and other assets	(9)	3,155
Other assets, noncurrent	57	29
Accounts payable	(2,754)	4,487
Accrued liabilities	(5,926)	(7,307)
Deferred revenue	(309)	(339)
Other liabilities, noncurrent	342	519
Net cash provided by operating activities	10,371	10,677
<b>Cash Flows from Investing Activities</b>		
Capital expenditures	(291)	(753)
Business acquisitions, net of notes payable and cash acquired		(30,204)
Internal software development costs	(651)	(559)
Purchases of marketable securities	(14,862)	(9,610)
Proceeds from sales and maturities of marketable securities	12,145	5,433
Other investing activities	4	28
Net cash used in investing activities	(3,655)	(35,665)
<b>Cash Flows from Financing Activities</b>		
Proceeds from exercise of common stock options	236	1,817
Principal payments on bank debt	(1,250)	(1,313)
Principal payments on acquisition-related notes payable	(3,568)	(1,213)
Excess tax benefits from stock-based compensation	24	35
Withholding taxes related to restricted stock net share settlement	(101)	(184)
Repurchases of common stock	(6,157)	
Net cash used in financing activities	(10,816)	(858)
Effect of exchange rate changes on cash and cash equivalents	17	25
Net decrease in cash and cash equivalents	(4,083)	(25,821)
Cash and cash equivalents at beginning of period	68,531	132,290



Edgar Filing: QUINSTREET, INC - Form 10-Q

Cash and cash equivalents at end of period	\$ 64,448	\$ 106,469
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid for interest	703	1,048
Cash paid for taxes	182	113
<b>Supplemental Disclosure of Noncash Investing and Financing Activities</b>		
Notes payable issued in connection with business acquisitions		161
Retirement of treasury stock	6,157	

See notes to condensed consolidated financial statements

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company**

QuinStreet, Inc. (the Company) is an online vertical marketing and media company. The Company was incorporated in California on April 16, 1999 and reincorporated in Delaware on December 31, 2009. The Company provides vertically oriented customer acquisition programs for its clients. The Company also provides hosted solutions for direct selling companies. The corporate headquarters are located in Foster City, California, with additional offices throughout the United States, Brazil and India.

**2. Summary of Significant Accounting Policies**

**Basis of Presentation**

*Principles of Consolidation*

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

*Unaudited Interim Financial Information*

The accompanying condensed consolidated financial statements and the notes to the condensed consolidated financial statements as of September 30, 2012 and for the three months ended September 30, 2012 and 2011 are unaudited. These unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012, as filed with the SEC on August 23, 2012. The condensed consolidated balance sheet at June 30, 2012 included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes required by GAAP.

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, include all adjustments (consisting only of normal recurring adjustments) necessary for the fair statement of the Company's condensed consolidated balance sheet at September 30, 2012, its condensed consolidated statements of operations for the three months ended September 30, 2012 and 2011, and its condensed consolidated statements of cash flows for the three months ended September 30, 2012 and 2011. The results of operations for the three months ended September 30, 2012 are not necessarily indicative of the results to be expected for the fiscal year ending June 30, 2013, or any other future period.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. On an ongoing basis, management evaluates these estimates, judgments and assumptions, including those related to revenue recognition, stock-based compensation, goodwill, intangible assets, long-lived assets, contingencies, and income taxes. The Company bases these estimates on historical and anticipated results and trends and on various other assumptions that the Company believes are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses that are not readily apparent from other sources. Actual results could differ from those estimates, and such differences could affect the results of operations reported in future periods.



---

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

***Accounting Policies***

The significant accounting policies are described in Note 2 to the consolidated financial statements included in the Annual Report on Form 10-K for the fiscal year ended June 30, 2012. There have been no significant changes in the accounting policies subsequent to June 30, 2012.

***Concentrations of Credit Risk***

No client accounted for 10% or more of total revenue for the three months ended September 30, 2012 or for the same period in fiscal year 2012. No client accounted for 10% or more of net accounts receivable as of September 30, 2012 or June 30, 2012.

***Fair Value of Financial Instruments***

The Company's financial instruments consist principally of cash equivalents, marketable securities, accounts receivable, accounts payable, acquisition-related promissory notes, an interest rate swap and a term loan. The fair value of the Company's cash equivalents is determined based on quoted prices in active markets for identical assets for its money market funds; and quoted prices for similar instruments in active markets for its U.S municipal securities and certificates of deposits that mature within 90 days. The recorded values of the Company's accounts receivable and accounts payable approximate their current fair values due to the relatively short-term nature of these accounts. The fair values of acquisition-related promissory notes approximate their recorded amounts as the interest rates on similar financing arrangements available to the Company at September 30, 2012 approximate the interest rates implied when these acquisition-related promissory notes were originally issued and recorded. The fair value of our interest rate swap is based upon valuation models as used by our counterparty. The Company believes that the fair value of the term loan approximates its recorded amount at September 30, 2012 as the interest rate on the term loan is variable and is based on market interest rates and after consideration of default and credit risk.

***Recent Accounting Pronouncements***

In September 2011, the FASB issued an update to the accounting standard for goodwill and intangibles. The revised standard allows entities to use a qualitative approach to test goodwill for impairment. It permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. The Company plans to adopt the new guidance by the fourth quarter of fiscal 2013, the period in which the Company performs its annual goodwill impairment test. The Company will conduct the test at an earlier date if indicators of possible impairment arise that would cause a triggering event. The Company does not believe that the adoption will have a material effect on the condensed consolidated financial statements.

In June 2011, the FASB issued guidance on the presentation of comprehensive income. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in stockholders' equity. Instead, an entity will be required to present either a continuous statement of net income (loss) and other comprehensive income (loss) or in two separate but consecutive statements. The Company's adoption of this portion of the new guidance in the first quarter of fiscal year 2013 require financial statement presentation changes only and did not have a material impact on its financial position, results of operations or cash flows. The new guidance also required entities to present reclassification adjustments out of accumulated other comprehensive income (loss) by component in both the statement in which net income (loss) is presented and the statement in which other comprehensive income is presented. However, in December 2011, the FASB issued guidance which indefinitely defers the guidance related to the presentation of reclassification adjustments.

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****3. Net (Loss) Income Attributable to Common Stockholders and Net (Loss) Income per Share**

Basic net (loss) income per share is computed by dividing net (loss) income by the weighted average number of shares of common stock outstanding during the period. Diluted net (loss) income per share is computed by using the weighted-average number of shares of common stock outstanding, including potential dilutive shares of common stock assuming the dilutive effect of outstanding stock options and restricted stock units using the treasury stock method.

The following table presents the calculation of basic and diluted net (loss) income per share:

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
	(In thousands, except per share data)	
<b>Numerator:</b>		
<b>Basic and Diluted:</b>		
Net (loss) income	\$ (137)	\$ 5,494
<b>Denominator:</b>		
<b>Basic:</b>		
Weighted average shares of common stock used in computing basic net income per share	42,812	47,505
<b>Diluted:</b>		
Weighted average shares of common stock used in computing basic net income per share	42,812	47,505
<b>Weighted average effect of dilutive securities:</b>		
Stock options	506	1,433
Restricted stock units	2	37
Weighted average shares of common stock used in computing diluted net income per share	43,320	48,975
<b>Net (loss) income per share:</b>		
Basic	\$ (0.00)	\$ 0.12
Diluted	\$ (0.00)	\$ 0.11
Securities excluded from weighted average shares used in computing diluted net income per share because the effect would have been anti-dilutive: <sup>(1)</sup>	7,299	4,461

<sup>(1)</sup> These weighted shares relate to anti-dilutive stock options and restricted stock units as calculated using the treasury stock method and could be dilutive in the future.

---

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**4. Fair Value Measurements and Marketable Securities**

Fair value is defined as the price that would be received on sale of an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. The FASB has established a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

The three levels of the fair value hierarchy under the guidance for fair value measurement are described below:

- Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities. Pricing inputs are based upon quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. The valuations are based on quoted prices of the underlying security that are readily and regularly available in an active market, and accordingly, a significant degree of judgment is not required. As of September 30, 2012, the Company used Level 1 assumptions for its money market funds.
- Level 2 Pricing inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. As of September 30, 2012, the Company used Level 2 assumptions for its U.S. municipal securities, certificates of deposits, acquisition-related promissory notes, term loan, and interest rate swap.
- Level 3 Pricing inputs are generally unobservable for the assets or liabilities and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models, and similar techniques. As of September 30, 2012, the Company did not have any Level 3 financial assets or liabilities.

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

The securities held by the Company as of September 30, 2012 and June 30, 2012 were categorized as follows in the fair value hierarchy (in thousands):

	Fair Value Measurements as of September 30, 2012		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Using Significant Other Observable Inputs (Level 2)	Total
<b>Assets:</b>			
U.S. municipal securities	\$	\$ 28,576	\$ 28,576
Certificates of deposit		14,516	14,516
Money market funds	20,788		20,788
	\$ 20,788	\$ 43,092	\$ 63,880
<b>Liabilities:</b>			
Acquisition-related promissory notes	\$	\$ 8,589	\$ 8,589
Term loan		94,214	94,214
Interest rate swap		1,536	1,536
	\$	\$ 104,339	\$ 104,339

	Fair Value Measurements as of June 30, 2012 Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Total
<b>Assets:</b>			
U.S. municipal securities	\$	\$ 30,861	\$ 30,861
Certificates of deposit		11,470	11,470
Money market funds	21,458		21,458
	\$ 21,458	\$ 42,331	\$ 63,789
<b>Liabilities:</b>			
Acquisition-related promissory notes	\$	\$ 12,215	\$ 12,215
Term loan		95,381	95,381

Interest rate swap		1,138	1,138
	\$	\$ 108,734	\$ 108,734

***Marketable Securities***

All liquid investments with maturities of three months or less at the date of purchase are classified as cash equivalents. Investments with maturities greater than three months at the date of purchase are classified as marketable securities. The Company's marketable securities have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments at the time of purchase and reevaluates the available-for-sale designation as of each balance sheet date. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of tax, reported as a component of stockholders' equity.



**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

The following table summarizes unrealized gains and losses related to available-for-sale securities held by the Company as of September 30, 2012 and June 30, 2012 (in thousands):

	<b>As of September 30, 2012</b>			
	<b>Gross</b>	<b>Gross</b>	<b>Gross</b>	<b>Estimated</b>
	<b>Amortized</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Fair</b>
	<b>Cost</b>	<b>Gains</b>	<b>Losses</b>	<b>Value</b>
U.S. municipal securities	\$ 28,564	\$ 12	\$	\$ 28,576
Certificates of deposit	14,524		8	14,516
Money market funds	20,788			20,788
	\$ 63,876	\$ 12	\$ 8	\$ 63,880

  

	<b>As of June 30, 2012</b>			
	<b>Gross</b>	<b>Gross</b>	<b>Gross</b>	<b>Estimated</b>
	<b>Amortized</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Fair</b>
	<b>Cost</b>	<b>Gains</b>	<b>Losses</b>	<b>Value</b>
U.S. municipal securities	\$ 30,851	\$ 10	\$	\$ 30,861
Certificates of deposit	11,480		10	11,470
Money market funds	21,458			21,458
	\$ 63,789	\$ 10	\$ 10	\$ 63,789

The Company did not realize any gains or losses from sales of its securities in the periods presented. As of September 30, 2012 and June 30, 2012, the Company did not hold securities that had maturity dates greater than one year.

**5. Acquisitions*****Acquisitions in Fiscal Year 2013***

The Company did not complete any acquisitions during the three months ended September 30, 2012.

***Acquisitions in Fiscal Year 2012***

In fiscal year 2012, the Company acquired certain assets of Ziff Davis Enterprise from Enterprise Media Group, Inc., a New York-based online media and marketing company in the business-to-business technology market, to broaden its registered user database and brand name in the business-to-business technology market. Additionally, the Company acquired 100% of the outstanding equity interests of ITBE, to broaden its registered user database and media access in the business-to-business technology market. The Company also acquired operations from eleven online publishing businesses. The Company also recorded \$4.6 million in earn-out payments related to a prior period acquisition as addition to goodwill.

The total purchase prices recorded were as follows (in thousands):

Edgar Filing: QUINSTREET, INC - Form 10-Q

	<b>Ziff Davis</b>	<b>ITBE</b>	<b>Other</b>	<b>Total</b>
Cash	\$ 17,270	\$ 23,961	\$ 14,620	\$ 55,851
Fair value of debt (net of imputed interest)			9,696	\$ 9,696
	\$ 17,270	\$ 23,961	\$ 24,316	\$ 65,547

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

The acquisitions were accounted for as purchase business combinations. The Company allocated the purchase price to tangible assets acquired, liabilities assumed and identifiable intangible assets acquired based on their estimated fair values. The excess of the purchase price over the aggregate fair value was recorded as goodwill. The goodwill is deductible for tax purposes. The following table summarizes the allocation of the purchase price and the estimated useful lives of the identifiable intangible assets acquired as of the date of the acquisitions (in thousands):

	<b>Ziff Davis</b>	<b>ITBE</b>	<b>Other</b>	<b>Total</b>	<b>Estimated Useful Life</b>
Tangible assets acquired	\$	\$ 3,597	\$	\$ 3,597	
Liabilities assumed	(255)	(1,868)		(2,123)	
Customer/publisher/advertiser relationships	4,120	3,230	435	7,785	3-5 years
Content	500	420	4,541	5,461	2-5 years
Website/trade/domain names	4,630	2,220	1,250	8,100	4-8 years
Registered user database	6,320	4,220		10,540	3 years
Acquired technology and other			560	560	4-5 years
Noncompete agreements		100	87	187	1-3.5 years
Goodwill	1,955	12,042	17,443	31,440	Indefinite
	\$ 17,270	\$ 23,961	\$ 24,316	\$ 65,547	

***Pro Forma Financial Information***

The unaudited pro forma financial information in the table below summarizes the combined results of operations for the Company and other companies that were acquired since the beginning of fiscal year 2012. The pro forma financial information includes the business combination accounting effects resulting from these acquisitions, including amortization charges from acquired intangible assets and the related tax effects as though the acquisitions were effected as of the beginning of fiscal year 2012. The unaudited pro forma financial information as presented below is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of fiscal year 2012.

	<b>Three Months Ended September 30, (In thousands)</b>	
	<b>2012</b>	<b>2011</b>
Net revenue	\$ 78,626	\$ 105,358
Net income	613	4,679
Basic net income per share	\$ 0.01	\$ 0.10
Diluted net income per share	\$ 0.01	\$ 0.10

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****6. Intangible Assets, Net and Goodwill**

Intangible assets, net balances, excluding goodwill, consisted of the following:

	September 30, 2012			June 30, 2012		
	Gross		Net	Gross		Net
	Carrying Amount	Accumulated Amortization	Carrying Amount	Carrying Amount	Accumulated Amortization	Carrying Amount
Customer/publisher/advertiser relationships	\$ 37,055	\$ (24,665)	\$ 12,390	\$ 37,045	\$ (23,017)	\$ 14,028
Content	62,128	(36,722)	25,406	62,076	(34,430)	27,646
Website/trade/domain names	31,635	(14,021)	17,614	31,615	(12,815)	18,800
Acquired technology and others	31,477	(21,242)	10,235	31,477	(19,507)	11,970
	\$ 162,295	\$ (96,650)	\$ 65,645	\$ 162,213	\$ (89,769)	\$ 72,444

Amortization of intangible assets was \$6.9 million and \$5.8 million in the three months ended September 30, 2012 and 2011, respectively.

Future amortization expense for the Company's acquisition-related intangible assets as of September 30, 2012 was as follows (in thousands):

Year Ending June 30,	Amortization
2013 (remaining nine months)	\$ 17,253
2014	18,977
2015	11,950
2016	8,411
2017	5,598
Thereafter	3,456
	\$ 65,645

The change in the carrying amount of goodwill for the Company's Direct Marketing Services, or DMS and Direct Selling Services, or DSS segments, discussed in Note 11, for the three months ended September 30, 2012 was as follows (in thousands):

	DMS	DSS	Total
Balance at June 30, 2012	\$ 241,818	\$ 1,231	\$ 243,049
Additions			
Other	(94)		(94)
Balance at September 30, 2012	\$ 241,724	\$ 1,231	\$ 242,955

In the three months ended September 30, 2012, there were no additions to goodwill as the Company did not complete any acquisitions during such period. Any change in goodwill amounts resulting from foreign currency translation are presented as *Other* in the above table.

Subsequent to September 30, 2012, the Company identified qualitative factors that could have affected the fair value of the DMS reporting unit, including changes in the competitive environment, current budgeted to actual performance, Company and peer market capitalization trends, and macro-economic conditions. The Company considered the results of its current fair value calculation and the amount by which the fair value of the reporting unit exceeded its carrying value, as well as the extent to which the inputs and the control premium assumptions in the fair value calculation would need to deteriorate in order for the DMS reporting unit's fair value to fall below carrying value. Based on the assessment of the foregoing factors, the Company concluded there to be no indication of goodwill impairment.

## **7. Debt**

### *Promissory Notes*

During the three months ended September 30, 2012, the Company did not issue any promissory notes for the acquisition of businesses because the Company completed no acquisitions.

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

During the three months ended September 30, 2011, the Company issued total promissory notes for the acquisition of businesses of \$0.2 million, net of imputed interest amounts of \$4,000. For these notes, interest was imputed such that the notes carry an interest rate commensurate with that available to the Company in the market for similar debt instruments. The Company recorded accretion of promissory notes of \$0.1 million for the three months ended September 30, 2012. Certain of the promissory notes are secured by the assets acquired in respect to which the notes were issued.

***Credit Facility***

In November 2011, the Company replaced its existing credit facility with a new \$300.0 million credit facility. The new facility consists of a \$100.0 million five-year term loan, with annual principal amortization of 5%, 10%, 15%, 20% and 50%, and a \$200.0 million five-year revolving credit line.

Borrowings under the credit facility are collateralized by substantially all of the Company's assets. Interest is payable at specified margins above either the Eurodollar Margin or the Prime Rate. The interest rate varies dependent upon the ratio of funded debt to adjusted EBITDA and ranges from Eurodollar Margin + 1.625% to 2.375% or Prime + 1.00% for the revolving credit line and from Eurodollar Margin + 2.00% to 2.75% or Prime + 1.00% for the term loan. Adjusted EBITDA is defined as net income (loss) less provision for taxes, depreciation expense, amortization expense, stock-based compensation expense, interest and other income (expense), and acquisition costs for business combinations. The interest rate margins for the new facility are 0.50% less than the commensurate margins under the Company's previous credit facility. The revolving credit line requires an annual facility fee of 0.375% of the revolving credit line capacity.

To reduce the Company's exposure to rising interest rates under the term loan, in February 2012, the Company entered into an interest rate swap encompassing the principal balances scheduled to be outstanding as of January 1, 2014, and, thereafter, such principal amount totaling \$85.0 million in January 2014 and amortizing to \$35.0 million in November 2016. The interest rate swap effectively fixes the Eurodollar Margin at 0.97%.

The credit facility expires in November 2016. The credit facility agreement restricts the Company's ability to raise additional debt financing and pay dividends, and also requires the Company to comply with other nonfinancial covenants. In addition, the Company is required to maintain financial ratios computed as follows:

1. A minimum fixed charge coverage ratio of 1.15:1, calculated as the ratio of: (i) trailing twelve months of adjusted EBITDA to (ii) the sum of capital expenditures, net cash interest expense, cash taxes, cash dividends and trailing twelve months payments of indebtedness. Payment of unsecured indebtedness is excluded to the degree that sufficient unused revolving credit line exists such that the relevant debt payment could be made from the credit facility.
2. A maximum funded debt to adjusted EBITDA ratio of 3:1, calculated as the ratio of: (i) the sum of all obligations owed to lending institutions, the face amount of any letters of credit, indebtedness owed in connection with acquisition-related notes and indebtedness owed in connection with capital lease obligations to (ii) trailing twelve months of adjusted EBITDA.

The Company was in compliance with the covenants of this new credit facility as of September 30, 2012 and June 30, 2012.

Upfront arrangement fees incurred in connection with the credit facility totaled \$1.5 million and will be deferred and amortized over the remaining term of the arrangement. \$96.3 million and \$97.5 million were outstanding under the term loan at September 30, 2012 and June 30, 2012, respectively. There was no outstanding balance under the revolving credit line.

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)*****Interest Rate Swap***

As discussed above, the Company entered into an interest rate swap to reduce its exposure to the financial impact of changing interest rates under its term debt. The Company does not speculate using derivative instruments. The Company entered into this derivative instrument arrangement solely for the purpose of risk management. The effective date of the swap is April 9, 2012 with a maturity date of November 4, 2016. At September 30, 2012, the Company had approximately \$85.0 million of notional amount outstanding in the swap agreement that exchanges a variable interest rate base (Eurodollar margin) for a fixed interest rate of 0.97% over the term of the agreement. This interest rate swap is designated as a cash flow hedge of the interest rate risk attributable to forecasted variable interest payments. The effective portion of the fair value gains or losses on this swap are included as a component of accumulated other comprehensive income (loss) on the condensed consolidated balance sheet. Any hedge ineffectiveness will be immediately recognized in earnings in the current period. At September 30, 2012, the fair value of the interest rate swap was \$1.5 million and the effective and ineffective portion of the interest rate swap was \$1.6 million and \$0.1 million, respectively.

***Debt Maturities***

The maturities of debt as of September 30, 2012 were as follows (in thousands):

<b>Year Ending June 30,</b>	<b>Promissory Notes</b>	<b>Credit Facility</b>
2013 (remaining nine months)	\$ 4,989	\$ 6,250
2014	3,364	12,500
2015	560	17,500
2016	50	20,000
2017		40,000
	8,963	96,250
Less: imputed interest and unamortized discounts	(374)	(2,036)
Less: current portion	(5,362)	(8,261)
<b>Noncurrent portion of debt</b>	<b>\$ 3,227</b>	<b>\$ 85,953</b>

***Letters of Credit***

The Company has a \$0.4 million letter of credit agreement with a financial institution that is used as collateral for fidelity bonds placed with an insurance company and a \$0.5 million letter of credit agreement with a financial institution that is used as collateral for the Company's corporate headquarters operating lease. The letters of credit automatically renew annually without amendment unless cancelled by the financial institutions within 30 days of the annual expiration date.

**8. Commitments and Contingencies*****Leases***

The Company leases office space and equipment under non-cancelable operating leases with various expiration dates through 2018. Rent expense for the three months ended September 30, 2012 and 2011 was \$0.8 million and \$0.9 million, respectively. The Company recognizes rent expense on a straight-line basis over the lease period and accrues for rent expense incurred but not paid.





**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

Future annual minimum lease payments under noncancelable operating leases as of September 30, 2012 were as follows (in thousands):

<b>Year Ending June 30,</b>	<b>Operating Leases</b>
2013 (remaining nine months)	\$ 2,461
2014	3,320
2015	3,186
2016	3,109
2017	2,748
2018 and thereafter	3,728
	<b>\$ 18,552</b>

***Guarantor Arrangements***

The Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity. The term of the indemnification period is for the officer or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts paid under certain circumstances and subject to deductibles and exclusions. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is not material. Accordingly, the Company had no liabilities recorded for these agreements as of September 30, 2012 and June 30, 2012.

In the ordinary course of its business, the Company from time to time enters into standard indemnification provisions in its agreements with its clients. Pursuant to these provisions, the Company may be obligated to indemnify its clients for certain losses suffered or incurred, including losses arising from violations of applicable law by the Company or by its third-party website publishers, losses arising from actions or omissions of the Company or its third party publishers, and for third-party claims that a Company product infringed upon any United States patent, copyright or other intellectual property rights. Where applicable, the Company generally limits its liabilities under such indemnities. With respect to its DSS products, the Company also generally reserves the right to resolve intellectual property infringement claims by providing a non-infringing alternative or by obtaining a license on reasonable terms, and failing that, by terminating its relationship with the client and thus terminating the infringing activity. Subject to these limitations, the term of such indemnity provisions is generally coterminous with the corresponding agreements but in some cases survives for a short period of time after termination of the agreement.

The potential amount of future payments to defend lawsuits or settle indemnified claims under these indemnification provisions is generally limited and the Company believes the estimated fair value of these indemnity provisions is not material, and accordingly, the Company had no liabilities recorded for these agreements as of September 30, 2012 and June 30, 2012.

***Litigation***

In September 2010, Lending Tree, LLC (Lending Tree) filed a patent infringement lawsuit against the Company in the United States District Court for the Western District of North Carolina, seeking a judgment that the Company has infringed a patent held by LendingTree, an injunctive order against the alleged infringing activities and an award for damages. If an injunction were to be granted, it could force the Company to stop or alter certain of its business activities, such as its lead generation in certain client verticals. On April 12, 2012, the Court held a claim construction hearing and issued an order construing certain disputed terms of the patent-in-suit. On August 9, 2012, the Court held another claim construction hearing and, on October 3, 2012, issued an order construing certain additional disputed terms of the patent-in-suit. The Company believes that it has meritorious defenses against LendingTree's claims. There can be no assurance, however, that the Company will

## Edgar Filing: QUINSTREET, INC - Form 10-Q

prevail in this matter and any adverse ruling may have a significant impact on its business and operating results. In addition, regardless of the outcome of the matter, the Company may incur significant legal fees defending the action until it is resolved. Neither the outcome of the litigation nor the amount or potential range of exposure, if any, associated with the litigation or any settlement can be assessed at this time.

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****9. Stock Benefit Plans*****Stock Incentive Plans***

The Company may grant incentive stock options ( ISOs ), nonstatutory stock options ( NQSOs ), restricted stock, restricted stock units, stock appreciation rights, performance-based stock awards and other forms of equity compensation, as well as performance cash awards under its 2010 Equity Incentive Plan (the 2010 Incentive Plan ), or NQSOs and restricted stock units to non-employee directors under the 2010 Non-Employee Directors Stock Award Plan (the Directors Plan ). To date, the Company has issued only ISOs, NQSOs and restricted stock units under the plans.

As of September 30, 2012, 7,066,233 shares were reserved and 4,362,284 shares were available for issuance under the 2010 Incentive Plan, and 1,170,000 shares were reserved and 900,000 shares were available for issuance under the Directors Plan.

***Stock-Based Compensation***

The Company estimates the fair value of stock options at the date of grant using the Black-Scholes option-pricing model. Options are granted with an exercise price equal to the fair value of the common stock at the date of grant. The weighted average Black-Scholes model assumptions and the weighted average grant date fair value of employee stock options for the three months ended September 30, 2012 and 2011 were as follows:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
Expected term (in years)	4.6	4.6
Expected volatility	55%	55%
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	0.7%	1.1%
Grant date fair value	\$ 4.36	\$ 5.35

The fair value of restricted stock units is determined based on the closing price of the Company's common stock on the grant date. Compensation expense is amortized net of estimated forfeitures on a straight-line basis over the requisite service period of the stock-based compensation awards.

**10. Stockholders Equity*****Stock Repurchase Program***

On November 3, 2011, the Board of Directors authorized a stock repurchase program allowing the Company to repurchase up to \$50.0 million of outstanding shares of its common stock. As of September 30, 2012, the Company had repurchased an aggregate of 5,263,484 shares of its common stock at a weighted average price of \$9.50 per share and had completed its repurchase program of \$50.0 million. Repurchases under this program took place in the open market and were made under a Rule 10b5-1 plan. The amount authorized by the Company's board of directors excludes broker commissions.

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

***Retirement of Treasury Stock***

For the quarter ended, September 30, 2012, the Company retired 638,365 shares of treasury stock. These retired shares are now included in the Company's pool of authorized but unissued shares. The retired treasury stock was initially recorded using the cost method and had a carrying value of approximately \$6.2 million at September 30, 2012. The Company's accounting policy upon the retirement of treasury stock is to deduct its par value from common stock, reduce additional paid-in capital by the amount recorded in additional paid-in capital when the stock was originally issued and any remaining excess of cost as a deduction from retained earnings.

**11. Segment Information**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about operating segments, including net sales and operating income before depreciation, amortization and stock-based compensation expense.

The Company determined its operating segments to be Direct Marketing Services, or "DMS", which derives revenue from fees earned through the delivery of qualified leads, clicks and, to a lesser extent, impressions, and Direct Selling Services, or "DSS", which derives revenue from the sale of direct selling services through a hosted solution. The Company's reportable operating segments consist of DMS and DSS. The accounting policies of the two reportable operating segments are the same as those described in Note 2.

The Company evaluates the performance of its operating segments based on operating income before depreciation, amortization and stock-based compensation expense.

The Company does not allocate most of its assets, nor its depreciation and amortization expense, stock-based compensation expense, interest income, interest expense or income tax expense by segment. Accordingly, the Company does not report such information.

**Table of Contents****QUINSTREET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

Summarized information by segment was as follows (in thousands):

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Net revenue by segment:		
DMS	\$ 78,334	\$ 100,841
DSS	292	383
Total net revenue	78,626	101,224
Segment operating income before depreciation, amortization, and stock-based compensation expense:		
DMS	11,824	20,378
DSS	151	255
Total segment operating income before depreciation, amortization, and stock-based compensation expense	11,975	20,633
Depreciation and amortization	(8,279)	(7,108)
Stock-based compensation expense	(2,770)	(3,374)
Total operating income	\$ 926	\$ 10,151

The following tables set forth net revenue and long-lived assets by geographic area (in thousands):

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Net revenue:		
United States	\$ 77,909	\$ 101,078
International	717	146
Total net revenue	\$ 78,626	\$ 101,224
	<b>September 30, 2012</b>	<b>June 30, 2012</b>
Property and equipment, net:		
United States	\$ 8,175	\$ 8,493
International	255	262
Total property and equipment, net:	\$ 8,430	\$ 8,755

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended June 30, 2012, filed with the Securities and Exchange Commission (SEC).*

*This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are often identified by the use of words such as, but not limited to, anticipate, believe, can, continue, could, estimate, expect, intend, may, will, plan, project, seek, should, target, will, would, and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified in Part II Item 1A. Risk Factors below, and those discussed in the sections titled Special Note Regarding Forward-Looking Statements and Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2012, filed with the SEC. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.*

**Management Overview**

QuinStreet is a leader in vertical marketing and media online. We have built a strong set of capabilities to engage Internet visitors with targeted media and to connect our marketing clients with their potential customers online. We focus on serving clients in large, information-intensive industry verticals where relevant, targeted media and offerings help visitors make informed choices, find the products that match their needs, and thus become qualified customer prospects for our clients.

We deliver cost-effective marketing results to our clients most typically in the form of a qualified lead or inquiry, or in the form of a qualified click. These leads or clicks can then convert into a customer or sale for clients at a rate that results in an acceptable marketing cost to them. We are typically paid by clients when we deliver qualified leads or clicks as defined by our agreements with such clients. Because we bear the costs of media, our programs must deliver value to our clients and provide for a media yield, or our ability to generate an acceptable margin on our media costs, that provides a sound financial outcome for us. Our general process is:

we own or access targeted media;

we run advertisements or other forms of marketing messages and programs in that media to create visitor responses or clicks through to client offerings;

we match these responses or clicks to client offerings that meet visitor interests or needs, converting visitors into qualified leads or clicks; and

we optimize client matches and media yield such that we achieve desired results for clients and a sound financial outcome for us. Our primary financial objective has been and remains creating revenue growth from sustainable sources, at target levels of profitability. Our primary financial objective is not to maximize profits, but rather to achieve target levels of profitability while investing in various growth initiatives, as we believe we are in the early stages of a large, long-term market.

## **Table of Contents**

Our Direct Marketing Services, or DMS, business accounted for substantially all of our net revenue in both the three months ended September 30, 2012 and 2011. Our DMS business derives net revenue from fees earned through the delivery of qualified leads and clicks and, to a lesser extent, display advertisements, or impressions. Through a vertical focus, targeted media presence and our technology platform, we are able to deliver targeted, measurable marketing results to our clients.

Our two largest client verticals within our DMS business are education and financial services. Our education client vertical represented 44% of net revenue in each of the three months ended September 30, 2012 and 2011. Our financial services client vertical represented 39% and 41% of net revenue in both the three months ended September 30, 2012 and 2011. Other DMS client verticals, consisting primarily of business-to-business technology, home services and medical, represented 17% and 15% of net revenue in the three months ended September 30, 2012 and 2011, respectively.

In addition, we derived less than 1% of our net revenue in each of the three months ended September 30, 2012 and 2011, from the provision of a hosted solution and related services for clients in the direct selling industry, also referred to as our Direct Selling Services, or DSS, business.

We generated substantially all of our revenue from sales to clients in the United States.

No client accounted for 10% or more of our net revenue in the three months ended September 30, 2012 or 2011.

## **Trends Affecting our Business**

### ***Client Verticals***

To date, we have generated the majority of our revenue from clients in our education and financial services client verticals. We expect that a majority of our revenue in fiscal year 2013 will be generated from clients in these two client verticals.

Our education client vertical has been significantly affected by the adoption of regulations affecting for-profit educational institutions over the past several years. The regulations have affected and are expected to continue to affect our clients' businesses and marketing practices, including an overall decrease in our clients' external marketing expenditures and a related decrease in our revenue from this client vertical. The effect of these regulations or any future regulations may continue to result in fluctuations in the volume and mix of our business with these clients.

Our revenue from our financial services client vertical has declined primarily due to changes in a search engine's algorithms which reduced or eliminated traffic from some third-party publishers, volume declines caused by losses of traffic from third-party publishers resulting from acquisitions of media sources by competitors, and increased competition for quality media.

### ***Acquisitions***

#### ***Acquisitions in Fiscal Year 2013***

We completed no acquisitions for the three months ended September 30, 2012.

#### ***Acquisitions in Fiscal Year 2012***

In February 2012, we acquired certain assets of Ziff Davis Enterprise from Enterprise Media Group, Inc., a New York-based online media and marketing company in the business-to-business technology market, in exchange for \$17.3 million in cash, to broaden our registered user database and brand name in the business-to-business technology market.

In August 2011, we acquired 100% of the outstanding equity interests of NarrowCast Group, LLC, or IT BusinessEdge, a Kentucky-based Internet media company in the business-to-business technology market, in exchange for \$24.0 million in cash, to broaden our registered user database and media access in the business-to-business technology market.

## **Table of Contents**

During fiscal year 2012, in addition to certain assets of Ziff Davis Enterprise and all of the equity interests of IT BusinessEdge, we acquired eleven other online publishing businesses.

### ***Development and Acquisition of Targeted Media***

One of the primary challenges of our business is finding or creating media that is targeted enough to attract prospects for our clients at costs that work for our business model. In order to continue to grow our business, we must be able to continue to find, develop or retain quality targeted media on a cost-effective basis. Our inability to find, develop or retain high quality targeted media has limited, during some periods, and may continue to limit, our ability to generate revenue.

### ***Seasonality***

Our results are subject to significant fluctuation as a result of seasonality. In particular, our quarters ending December 31 (our second fiscal quarter) are typically characterized by seasonal weakness. In our second fiscal quarters, there is lower availability of lead supply from some forms of media during the holiday period on a cost effective basis and some of our clients request fewer leads due to holiday staffing. In our quarters ending March 31 (our third fiscal quarter), this trend generally reverses with better lead availability and often new budgets at the beginning of the year for our clients with fiscal years ending December 31.

### **Basis of Presentation**

#### ***General***

We operate in two segments: DMS and DSS. For further discussion and financial information about our reporting segments, see Note 11 to our condensed consolidated financial statements.

#### ***Net Revenue***

*DMS.* Our DMS business generates revenue from fees earned through the delivery of qualified leads, clicks and, to a lesser extent, display advertisements, or impressions. We deliver targeted and measurable results through a vertical focus that we classify into the following client verticals: education, financial services and other (which includes business-to-business technology, home services and medical).

*DSS.* Our DSS business generated less than 1% of net revenue in both the three months ended September 30, 2012 and 2011. We expect DSS to continue to represent an immaterial portion of our business.

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

Cost of revenue consists primarily of media costs, personnel costs, amortization of acquisition-related intangible assets, depreciation expense and amortization of internal software development costs relating to revenue-producing technologies. Media costs consist primarily of fees paid to website publishers that are directly related to a revenue-generating event and pay-per-click, or PPC, ad purchases from Internet search companies. We pay these Internet search companies and website publishers on a revenue-share, a cost-per-lead, or CPL, cost-per-click, or CPC, and cost-per-thousand-impressions, or CPM, basis. Personnel costs include salaries, stock-based compensation expense, bonuses and employee benefit costs. Personnel costs are primarily related to individuals associated with maintaining our servers and websites, our editorial staff, client management, creative team, compliance group and media purchasing analysts. Costs associated with software incurred in the development phase or obtained for internal use are capitalized, and amortized in cost of revenue over the software's estimated useful life. We anticipate that our cost of revenue will trend with our overall revenue.

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

We classify our operating expenses into three categories: product development, sales and marketing, and general and administrative. Our operating expenses consist primarily of personnel costs and, to a lesser extent, professional services fees, rent and allocated costs. Personnel costs for each category of operating expenses generally include salaries, stock-based compensation expense, bonuses, commissions and employee benefit costs.





## **Table of Contents**

*Product Development.* Product development expenses consist primarily of personnel costs and professional services fees associated with the development and maintenance of our technology platforms, development and launching of our websites, product-based quality assurance and testing. In this recent period of declining revenues, we are constraining expenses generally. However, we believe that continued investment in technology is critical to attaining our strategic objectives and, as a result, we expect product development expenses to increase in absolute dollars in the future, if and when we return to growth.

*Sales and Marketing.* Sales and marketing expenses consist primarily of personnel costs and, to a lesser extent, professional services fees, travel costs and advertising. In this recent period of declining revenues, we are constraining expenses generally. However, we expect sales and marketing expenses to increase in absolute dollars as we hire additional personnel in sales and marketing to support our product offerings, if and when we return to growth.

*General and Administrative.* General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, corporate and business development, employee benefits and compliance, technical support and other administrative personnel, as well as accounting and legal professional services fees and insurance. We expect general and administrative expenses to increase in absolute dollars in future periods as we continue to invest in corporate infrastructure and expanding our business internationally, including increased legal and accounting costs.

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

Interest and other income (expense), net, consists primarily of interest expense, other income and expense and interest income. Interest expense is related to our credit facility, interest rate swap and promissory notes issued in connection with our acquisitions, and includes imputed interest on non-interest bearing notes. Borrowings under our credit facility, and the aggregate principal amount of outstanding promissory notes, and related interest expense could increase if we make additional acquisitions through debt financing. Interest income represents interest earned on our cash, cash equivalents and marketable securities, which may increase or decrease depending on market interest rates and the amounts invested.

Other income (expense), net, includes foreign currency exchange gains and losses and other non-operating items.

### ***Income Tax Expense***

We are subject to tax in the United States as well as other tax jurisdictions or countries in which we conduct business. Earnings from our limited non-U.S. activities are subject to local country income tax and may be subject to U.S. income tax.

### **Critical Accounting Policies, Estimates and Judgments**

In presenting our consolidated financial statements in conformity with U.S. generally accepting accounting principles, or GAAP, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses and related disclosures.

Some of the estimates and assumptions we are required to make relate to matters that are inherently uncertain as they pertain to future events. We base these estimates and assumptions on historical experience or on various other factors that we believe to be reasonable and appropriate under the circumstances. On an ongoing basis, we reconsider and evaluate our estimates and assumptions. Actual results may differ significantly from these estimates.

We believe that the critical accounting policies listed below involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements.

Revenue recognition;

Stock-based compensation;

Valuation of goodwill and intangible assets;

Valuation of long-lived assets; and

Income taxes.

**Table of Contents**

There have been no material changes to our critical accounting policies, estimates and judgments disclosed in our Annual Report on Form 10-K subsequent to June 30, 2012, except for our test for impairment of goodwill discussed below. For further information on our critical and other significant accounting policies and estimates, see Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operation of our Annual Report on Form 10-K for the year ended June 30, 2012, filed with the SEC.

**Recently Issued Accounting Standards**

See Note 2 to our condensed consolidated financial statements.

**Results of Operations**

The following table sets forth our consolidated statement of operations for the periods indicated (\$ in thousands):

	<b>Three Months Ended September 30,</b>			
	<b>2012</b>		<b>2011</b>	
Net revenue	\$ 78,626	100.0%	\$ 101,224	100.0%
Cost of revenue <sup>(1)</sup>	65,190	82.9	75,748	74.8
Gross profit	13,436	17.1	25,476	25.2
Operating expenses: <sup>(1)</sup>				
Product development	4,893	6.2	6,074	6.0
Sales and marketing	3,691	4.7	4,034	4.0
General and administrative	3,926	5.0	5,217	5.2
Operating income	926	1.2	10,151	10.0
Interest income	28	0.0	38	0.0
Interest expense	(1,012)	(1.3)	(1,083)	(1.1)
Other income (expense), net	46	0.1	(31)	(0.0)
(Loss) income before income taxes	(12)	(0.0)	9,075	9.0
Provision for taxes	(125)	(0.2)	(3,581)	(3.5)
Net (loss) income	\$ (137)	(0.2)%	\$ 5,494	5.4%

<sup>(1)</sup> Cost of revenue and operating expenses include stock-based compensation expense as follows:

Cost of revenue	\$ 923	1.2%	\$ 1,179	1.2%
Product development	693	0.9	660	0.7
Sales and marketing	765	1.0	779	0.8
General and administrative	389	0.5	756	0.7

**Table of Contents****Net Revenue**

	<b>Three Months Ended September 30,</b>		<b>Three Months % Change</b>
	<b>2012</b>	<b>2011</b>	
	<b>(in thousands)</b>		
Net revenue	\$ 78,626	\$ 101,224	(22%)
Cost of revenue	65,190	75,748	(14%)
<b>Gross profit</b>	<b>\$ 13,436</b>	<b>\$ 25,476</b>	<b>(47%)</b>

Net revenue decreased \$22.6 million, or 22%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011. Our education client vertical revenue decreased \$9.7 million, or 22%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011, as a result of our education clients purchasing fewer inquiries due, in part, to uncertainty surrounding new regulations affecting for-profit educational institutions. Our financial services client vertical revenue decreased \$11.6 million, or 28%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011, due to lower volumes resulting from reduced availability of quality publisher media. Our other client verticals revenue decreased \$1.3 million, or 8%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011, primarily due to decreased client demand in our home services client vertical and partially offset by increased revenue in our business-to-business technology client vertical as a result of our acquisitions of IT BusinessEdge and certain assets of Ziff Davis Enterprise in fiscal year 2012.

**Cost of Revenue**

Cost of revenue decreased \$10.6 million, or 14%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011, driven by decreased media costs of \$11.4 million due to lower lead and click volumes and decreased personnel costs of \$0.5 million, partially offset by increased amortization of acquisition-related intangible assets of \$1.1 million. The decreased personnel costs were attributable to a reduction in average headcount. Gross margin, which is the difference between net revenue and cost of revenue as a percentage of net revenue was 17% for the three months ended September 30, 2012 compared to 25% for the three months ended September 30, 2011. Gross margin declined by 8%, primarily driven by an increase as a percent of net revenue in personnel and other fixed costs, and higher amortization expenses.

**Operating Expenses**

	<b>Three Months Ended September 30,</b>		<b>Three Months % Change</b>
	<b>2012</b>	<b>2011</b>	
	<b>(in thousands)</b>		
Product development	\$ 4,893	\$ 6,074	(19%)
Sales and marketing	3,691	4,034	(9%)
General and administrative	3,926	5,217	(25%)
<b>Operating expenses</b>	<b>\$ 12,510</b>	<b>\$ 15,325</b>	<b>(18%)</b>

**Product Development Expenses**

Product development expenses decreased \$1.2 million, or 19%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011. This was primarily due to decreased personnel costs of \$0.9 million resulting from a reduction in average headcount and increased capitalized software expenses of \$0.1 million.

**Table of Contents***Sales and Marketing Expenses*

Sales and marketing expenses decreased \$0.3 million, or 9%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011. This was primarily due to decreased personnel costs of \$0.2 million resulting from a reduction in average headcount.

*General and Administrative Expenses*

General and administrative expenses decreased \$1.3 million, or 25%, for the three months ended September 30, 2012, compared to the three months ended September 30, 2011. This was primarily due to decreased legal costs of \$0.5 million related to ongoing litigation, decreased direct acquisition costs of \$0.2 million related to acquisitions and decreased personnel costs of \$0.2 million resulting from a reduction in average headcount.

*Interest and Other Income (Expense), Net*

	Three Months Ended September 30, 2012		Three Months % Change
	(in thousands)		
Interest income	\$ 28	\$ 38	(26%)
Interest expense	(1,012)	(1,083)	(7%)
Other income (expense), net	46	(31)	(248%)
Interest and other income (expense), net	\$ (938)	\$ (1,076)	(13%)

Interest and other income (expense), net decreased \$0.1 million, or 13% for the three months ended September 30, 2012, compared to the three months ended September 30, 2011, primarily due to decreased debt obligations in the three months ended September 30, 2012.

*Provision for Taxes*

	Three Months Ended September 30, 2012		Three Months % Change
	(in thousands)		
Provision for taxes	\$ 125	\$ 3,581	(97%)

We calculated our corporate tax expense based on applying the rules of FIN 18 and calculated the annual effective tax rate for the year and then applied that to the quarterly pre-tax book income. We estimate our annual effective tax rate to be 42%. This differs from the annual statutory rate of 35% due to various permanent differences most significantly stock based compensation. The current quarter tax expense was determined based on applying the estimated annual effective rate to the pre-tax book loss and applying the impact of the discrete reporting of stock based compensation incurred during the three months ended September 30th, 2012.

**Liquidity and Capital Resources**

Our principal sources of liquidity as of September 30, 2012, consisted of cash and cash equivalents of \$64.4 million, short-term marketable securities of \$39.1 million, cash we expect to generate from operations, and our \$200.0 million revolving credit facility, which is committed until November 2016, all of which is available to be drawn, subject to compliance with applicable covenants. Our cash and cash equivalents are maintained in highly liquid investments with remaining maturities of 90 days or less at the time of purchase. We believe our cash equivalents are liquid and accessible.



**Table of Contents**

Our short-term and long-term liquidity requirements primarily arise from our working capital requirements, debt service on our \$100.0 million term loan and acquisitions from time to time. Our primary operating cash requirements include the payment of media costs, personnel costs, costs of information technology systems and office facilities. Our ability to fund these requirements will depend on our future cash flows, which are determined by future operating performance and are, therefore, subject to prevailing global macroeconomic conditions and financial, business and other factors, some of which are beyond our control, and also our ability to access our credit facility. Even though we may not need additional funds, we may still elect to obtain additional debt or equity securities or draw down on or increase our borrowing capacity under our current credit facility for other reasons.

We believe that our existing cash, cash equivalents, short-term marketable securities, cash generated from operations and our available borrowings under the credit facility will be sufficient to satisfy our currently anticipated cash requirements through at least the next 12 months.

The following table summarizes our cash flows for the periods indicated:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>
	<b>(in thousands)</b>	
Cash flows provided by operating activities	\$ 10,371	\$ 10,677
Cash flows used in investing activities	(3,655)	(35,665)
Cash flows (used in) provided by financing activities	(10,816)	(858)

***Operating Activities***

Our net cash provided by operating activities is primarily the result of our net (loss) income adjusted for non-cash expenses such as depreciation and amortization, stock-based compensation expense and changes in working capital components, and is influenced by the timing of cash collections from our clients and cash payments for purchases of media and other expenses.

Net cash flows provided by operating activities was \$10.4 million for the three months ended September 30, 2012 as compared to \$10.7 million for the three months ended September 30, 2011.

Net cash flow provided by operating activities for the three months ended September 30, 2012 consisted of non-cash charges of \$10.8 million, partially offset by contributions to working capital of \$0.3 million and net loss of \$0.1 million. The non-cash charges primarily consisted of depreciation and amortization of \$8.3 million and stock-based compensation expense net of tax benefits of \$2.7 million. The contribution to working capital accounts was primarily due to a net decrease in accounts payable and accrued liabilities of \$8.7 million and a decrease in accounts receivable of \$8.3 million. The decrease in accounts receivable, as well as the net decrease in accounts payable and accrued liabilities, are primarily due to timing of payments.

Net cash provided by operating activities in the three months ended September 30, 2011 was due to net income of \$5.5 million, non-cash depreciation, amortization and stock-based compensation expense of \$10.5 million and a decrease in prepaid expenses and other assets of \$3.2 million, partially offset by an increase in accounts receivable of \$6.1 million and a net decrease in accounts payable and accrued liabilities of \$2.8 million. The decrease in prepaid expenses and other assets, accounts receivable, as well as the net decrease in accounts payable and accrued liabilities, are primarily due to timing of payments.

***Investing Activities***

Our investing activities include acquisitions of media websites and businesses, capital expenditures and capitalized internal development costs.

Net cash flows used in investing activities was \$3.7 million for the three months ended September 30, 2012 as compared to net cash flows used in investing activities of \$35.7 million for the three months ended September 30, 2011.



**Table of Contents**

Cash used in investing activities in the three months ended September 30, 2012 was primarily due to net investments in marketable securities of \$2.7 million. Capital expenditures and internal software development costs totaled \$0.9 million in the three months ended September 30, 2012.

Cash used in investing activities in the three months ended September 30, 2011 was primarily due to our acquisition of ITBE for a cash payment of \$24.0 million and the purchases of the operations of five other online publishing businesses for an aggregate of \$6.6 million in cash payments, as well as net investments in marketable securities of \$4.2 million. Capital expenditures and internal software development costs totaled \$1.3 million in the three months ended September 30, 2011.

**Financing Activities**

Net cash flows used in financing activities was \$10.8 million for the three months ended September 30, 2012 as compared to net cash flows used in financing activities of \$0.9 million for the three months ended September 30, 2011.

Cash used in financing activities in the three months ended September 30, 2012 was primarily due to repurchases of our common stock of \$6.2 million and principal payments on acquisition-related notes payable and our term loan and related fees of \$4.8 million, partially offset by exercises of stock options of \$0.2 million.

Cash used in financing activities in the three months ended September 30, 2011 was primarily due to proceeds from the exercise of stock options of \$1.8 million, partially offset by \$2.5 million in principal payments on our term loan and acquisition-related promissory notes.

**Off-Balance Sheet Arrangements**

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

**Contractual Obligations**

Our contractual obligations relate primarily to borrowings under our credit facility, acquisition-related notes payable, operating leases and purchase obligations. There have been no significant changes to our contractual obligations from those disclosed in our Annual Report on Form 10-K for the year ended June 30, 2012.

The following table summarizes our contractual obligations for the periods indicated:

Year Ending June 30,	Promissory Notes	Credit Facility	Operating Leases	Total
2013 (remaining nine months)	\$ 4,989	\$ 6,250	\$ 2,461	\$ 13,700
2014	3,364	12,500	3,320	19,184
2015	560	17,500	3,186	21,246
2016	50	20,000	3,109	23,159
2017		40,000	2,748	42,748
2018 and thereafter			3,728	3,728
<b>Total</b>	<b>\$ 8,963</b>	<b>\$ 96,250</b>	<b>\$ 18,552</b>	<b>\$ 123,765</b>

**Credit Facility**

In November 2011, we replaced our existing \$225.0 million credit facility with a new \$300.0 million credit facility. The new facility consists of a \$100.0 million five-year term loan, with annual principal amortization of 5%, 10%, 15%, 20% and 50%, and a \$200.0 million five-year revolving credit line.



**Table of Contents**

Borrowings under the credit facility are collateralized by substantially all of our assets. Interest is payable at specified margins above either the Eurodollar Margin or the Prime Rate. The interest rate varies dependent upon the ratio of funded debt to adjusted EBITDA and ranges from Eurodollar Margin + 1.625% to 2.375% or Prime + 1.00% for the revolving credit line and from Eurodollar Margin + 2.00% to 2.75% or Prime + 1.00% for the term loan. Adjusted EBITDA is defined as net income (loss) less provision for taxes, depreciation expense, amortization expense, stock-based compensation expense, interest and other income (expense), and acquisition costs for business combinations. The interest rate margins for the new facility are 0.50% less than the commensurate margins under our previous credit facility. The revolving credit line requires a facility fee of 0.375% of the revolving credit line capacity.

To reduce our exposure to rising interest rates under the term loan, in February 2012, we entered into an interest rate swap encompassing the principal balances scheduled to be outstanding in January 2014 and thereafter, such principal amount totaling \$85.0 million in January 2014 and amortizing to \$35.0 million in November 2016. The interest rate swap effectively fixes the Eurodollar Margin at 0.97%.

The credit facility expires in November 2016. The credit facility restricts our ability to raise additional debt financing and pay dividends, and also requires us to comply with other nonfinancial covenants. In addition, we are required to maintain financial ratios computed as follows:

1. A minimum fixed charge coverage ratio of 1.15:1, calculated as the ratio of (i) trailing twelve months of adjusted EBITDA to (ii) the sum of capital expenditures, net cash interest expense, cash taxes, cash dividends and trailing twelve months payments of indebtedness. Payment of unsecured indebtedness is excluded to the degree that sufficient unused revolving credit line capacity exists such that the relevant debt payment could be made from the credit facility.
2. A maximum funded debt to adjusted EBITDA ratio of 3:1, calculated as the ratio of (i) the sum of all obligations owed to lending institutions, the face amount of any letters of credit, indebtedness owed in connection with acquisition-related notes and indebtedness owed in connection with capital lease obligations to (ii) trailing twelve months of adjusted EBITDA.

We were in compliance with the covenants of our new credit facility as of September 30, 2012 and June 30, 2012.

***Interest Rate Swap***

As discussed above, we entered into an interest rate swap to reduce our exposure to the financial impact of changing interest rates under our term loan. The effective date of the swap is April 9, 2012 with a maturity date of November 4, 2016. At September 30, 2012, we had approximately \$85.0 million of notional amount outstanding in the swap agreement that exchanges a variable interest rate base (Eurodollar margin) for a fixed interest rate of 0.97% over the term of the agreement. This interest rate swap is designated as a cash flow hedge of the interest rate risk attributable to forecasted variable interest payments. The effective portion of the fair value gains or losses on this swap will be included as a component of accumulated other comprehensive income (loss) on the condensed consolidated balance sheets.

At September 30, 2012, our interest rate swap qualifies as a cash flow hedge. For this qualifying hedge, the effective portion of the change in fair value will be recognized through earnings when the underlying transaction being hedged affects earnings, thereby allowing the swap's gains and losses to offset interest expense from the term loan on the income statement. Any hedge ineffectiveness is recognized in earnings in the current period.

***Headquarter Lease***

We entered into a lease agreement in February 2010 for approximately 63,998 square feet of office space located at 950 Tower Lane, Foster City, California. The term of the lease began on November 1, 2010 and expires on October 31, 2018. The monthly base rent was abated for the first 12 calendar months under the lease, and will remain at \$0.1 million through the 24th calendar month of the term of the lease. After this 24 month period, monthly base rent will increase to \$0.2 million for the subsequent 12 months and then increase approximately 3% after each 12-month anniversary during the remaining term, including any extensions under our options to extend. We have two options to extend the term of the lease for one additional year for each option following the expiration date of the lease or renewal term, as applicable.

---

**Table of Contents**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risks in the ordinary course of our business. These risks include primarily interest rate and foreign currency exchange risks.

**Interest Rate Risk**

We invest our cash equivalents and short-term investments primarily in liquid, highly-rated U.S. government or municipal fixed income securities, certificates of deposit with financial institutions and money market funds. Unrestricted cash, cash equivalents and short-term investments are held for working capital purposes and acquisition financing. We do not enter into investments for trading or speculative purposes. We believe that we do not have material exposure to changes in the fair value of these investments as a result of changes in interest rates due to the short-term nature of our investments. Declines in interest rates may reduce future investment income. However, a hypothetical decline of 1% in the interest rate on our investments would not have a material effect on our consolidated financial statements.

As of September 30, 2012, our credit facility had a borrowing capacity of \$300.0 million with \$96.3 million in term loans outstanding, and no amounts outstanding under our revolving line of credit. Interest on borrowings under the credit facility is payable quarterly at specified margins above either the Eurodollar Margin or the Prime Rate. Our exposure to interest rate risk under the credit facility will depend on the extent to which we utilize the facility. To reduce our exposure to rising interest rates under the term loan, in February 2012, we entered into an interest rate swap encompassing the principal balances scheduled to be outstanding as of January 1, 2014, and, thereafter, such principal amount will total \$85.0 million on January 1, 2014 and amortize to \$35.0 million on November 4, 2016. The interest rate swap effectively fixes the Eurodollar Margin at a fixed rate of 0.97%. A hypothetical change of 1% from prevailing interest rates as of September 30, 2012 would affect our interest expense and the fair value of the swap by less than \$0.2 million.

In addition to the \$85.0 million of term loans covered by the interest rate swap as of September 30, 2012, the Company also had variable rate debt outstanding of \$11.3 million.

A hypothetical increase of 1% in the Eurodollar Margin or Prime Rate-based interest rate on our variable rate debt outstanding of \$11.3 million as of September 30, 2012 would result in an increase in our interest expense of \$0.1 million per year, assuming constant borrowing levels.

**Foreign Currency Exchange Risk**

To date, our international client agreements have been predominately denominated in U.S. dollars, and accordingly, we have limited exposure to foreign currency exchange rate fluctuations related to client agreements, and do not currently engage in foreign currency hedging transactions. As the local accounts for some of our foreign operations are maintained in the local currency of the respective country, we are subject to foreign currency exchange rate fluctuations associated with the remeasurement to U.S. dollars. A hypothetical change of 10% in foreign currency exchange rates would not have a material effect on our consolidated financial condition or results of operations.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2012. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act, means controls and other procedures of a company that

**Table of Contents**

are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2012, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

**Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rules 13a-15(d) and 15d-15(d) of the Securities Exchange Act that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

---

**Table of Contents**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In September 2010, Lending Tree, LLC ( Lending Tree ) filed a patent infringement lawsuit against the Company in the United States District Court for the Western District of North Carolina, seeking a judgment that the Company has infringed a patent held by LendingTree, an injunctive order against the alleged infringing activities and an award for damages. If an injunction were to be granted, it could force the Company to stop or alter certain of its business activities, such as its lead generation in certain client verticals. On April 12, 2012, the Court held a claim construction hearing and issued an order construing certain disputed terms of the patent-in-suit. On August 9, 2012, the Court held another claim construction hearing and, on October 3, 2012, issued an order construing certain additional disputed terms of the patent-in-suit. The Company believes that it has meritorious defenses against LendingTree's claims. There can be no assurance, however, that the Company will prevail in this matter and any adverse ruling may have a significant impact on its business and operating results. In addition, regardless of the outcome of the matter, the Company may incur significant legal fees defending the action until it is resolved. Neither the outcome of the litigation nor the amount or potential range of exposure, if any, associated with the litigation or any settlement can be assessed at this time.

From time to time, we may become involved in other legal proceedings and claims arising in the ordinary course of our business.

**ITEM 1A. RISK FACTORS**

*Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Quarterly Report on Form 10-Q. If any of such risks actually occur, our business, operating results or financial condition could be adversely affected. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment.*

**Risks Related to Our Business and Industry**

*We operate in an immature industry and have a relatively new business model, which makes it difficult to evaluate our business and prospects.*

We derive nearly all of our revenue from the sale of online marketing and media services, which is an immature industry that has undergone rapid and dramatic changes in its short history. The industry in which we operate is characterized by rapidly-changing Internet media, evolving industry standards, and changing user and client demands. Our business model is also evolving and is distinct from many other companies in our industry, and it may not be successful. As a result of these factors, the future revenue and income potential of our business is uncertain and has recently experienced declines, and we may not be able to return to our previous growth rates. Any evaluation of our business and our prospects must be considered in light of these factors and the risks and uncertainties often encountered by companies in an immature industry with an evolving business model such as ours. Some of these risks and uncertainties relate to our ability to:

maintain and expand client relationships;

respond to adverse and changing regulations in our verticals, including our education vertical;

sustain and grow relationships with third-party website publishers and other sources of web visitors;

sustain and increase the number of visitors to our websites;

manage our operations and implement and improve our operational, financial and management controls;

Edgar Filing: QUINSTREET, INC - Form 10-Q

overcome challenges presented by adverse global economic conditions as they impact spending in our client verticals;

raise capital at attractive costs, or at all;

acquire and integrate websites and other businesses;

---

**Table of Contents**

successfully expand our footprint in our existing client verticals and enter new client verticals;

respond effectively to competition and potential negative effects of competition on profit margins;

attract and retain qualified management, employees and independent service providers;

successfully introduce new processes and technologies and upgrade our existing technologies and services;

protect our proprietary technology and intellectual property rights; and

respond to government regulations relating to the Internet, marketing in our client verticals, personal data protection, email, software technologies and other aspects of our business.

If we are unable to address these risks, our business, results of operations and prospects could suffer.

***We are dependent on two market verticals for a majority of our revenue. Negative changes in the economic condition, market dynamics or regulatory environment in these verticals has caused and may continue to cause our revenue to decline and our business and growth to suffer.***

To date, we have generated a substantial portion of our revenue from clients in our education and financial services client verticals. We expect that a majority of our revenue in the near term will continue to be generated from clients in our education and financial services client verticals. Changes in the market conditions or the regulatory environment in these two highly-regulated client verticals have negatively impacted and may continue to negatively impact our clients' businesses, marketing practices and budgets and, therefore, adversely affect our financial results.

***There is significant activity and uncertainty in the regulatory and legislative environment in the for-profit education sector. Regulatory and legislative changes have negatively affected and could continue to negatively affect our clients' businesses, marketing practices and budgets and could impact demand, pricing or form of our services, any or all of which could have a material adverse impact on our financial results.***

We generate nearly half of our revenue from our education client vertical and nearly all of that revenue is generated from for-profit educational institutions. There is intense governmental interest in and scrutiny of the for-profit education industry and a high degree of focus on marketing practices in the industry. The Department of Education has promulgated regulations that have adversely impacted and could continue to adversely impact us and our education clients. The intense focus on the for-profit education industry could result in further regulatory or legislative action. We cannot predict whether this will happen or what the impact could be on our financial results.

The Higher Education Act, administered by the U.S. Department of Education, provides that to be eligible to participate in Federal student financial aid programs, an educational institution must enter into a program participation agreement with the Secretary of the Department of Education. The agreement includes a number of conditions with which an institution must comply to be granted initial and continuing eligibility to participate. Among those conditions is a prohibition on institutions providing to any individual or entity engaged in recruiting or admission activities any commission, bonus, or other incentive payment based directly or indirectly on success in securing enrollments. The Department of Education issued regulations on incentive compensation and other matters which became effective July 1, 2011. The Department's regulations repeal all safe harbors regarding incentive compensation which existed under the prior regulations, including the safe harbor for Internet-based recruiting and admissions activities. The elimination of the safe harbors has created uncertainty for us and our education clients and impacts the way in which we are paid by our clients and, accordingly, has reduced the amount of revenue we generate from the education client vertical. Moreover, given the regulatory uncertainty affecting our education client base, we believe that overall external market spending by education clients has declined in recent periods, and there can be no assurance as to when or if such spending will return to prior levels.

In addition, the same regulations impose strict liability on educational institutions for misrepresentations made by entities, like us, who contract with the institutions to provide marketing services. As a result, some of our clients have demanded, and we have agreed in some cases to, increased assumptions of risk in our contracts as well as indemnification for actions by us and, in some cases, by our third-party publishers. As a result of this increased contractual exposure with some clients, we could become subject to costly litigation and be required to pay substantial damages or indemnification claims. We could also experience damage to any reputation for our violation of an applicable regulation and the



unauthorized or unlawful acts of third-party website publishers.

## **Table of Contents**

Other regulations could also negatively impact our for-profit education clients. For example, the regulations on gainful employment that restrict or eliminate federal financial aid to students in programs where certain debt-to-income ratios and loan default rates are not satisfied could result in the elimination or reduction in some of our clients' programs. Over the past year, enrollments have dropped significantly at some of our clients, caused in part by changes being made as a result of gainful employment regulations, which became effective July 1, 2012. In addition, some of our large for-profit education clients have indicated that in coming years they may violate the 90/10 rule, whereby for-profit institutions must receive at least 10 percent of their revenue from sources other than federal student financial aid. If a for-profit institution fails to comply with the rule for two consecutive fiscal years, it may lose its eligibility to receive student-aid funds for at least two years. These and other regulations or a failure of our clients to comply with such regulations, could adversely affect our clients' businesses and, as a result, affect or materially reduce the amount of revenue we generate from those clients.

Moreover, some of our for-profit education clients have had and may in the future have issues regarding their academic accreditation, which could adversely affect their ability to offer certain degree programs. If any of our significant education clients lose their accreditation, they are likely to reduce and may even eliminate their external marketing spending, which could adversely affect our financial results.

Our for-profit education clients have been significantly affected by the adoption of and uncertainty surrounding the new regulations over the past several years. The regulations have affected and are expected to continue to affect our clients' businesses and marketing practices, including an overall decrease in our clients' external marketing expenditures and a related decrease in our revenue from this client vertical. The effect of these regulations may continue to result in fluctuations in the volume and mix of our business with these clients.

***We depend on third-party website publishers for a significant portion of our visitors, and any decline in the supply of media available through these websites or increase in the price of this media could cause our revenue to decline or our cost to reach visitors to increase.***

A significant portion of our revenue is attributable to visitor traffic originating from arrangements that we have with third-party publishers. In many instances, website publishers can change the media inventory they make available to us at any time and, therefore, impact our revenue. In addition, website publishers may place significant restrictions on our offerings. These restrictions may prohibit advertisements from specific clients or specific industries, or restrict the use of certain creative content or formats. If a website publisher decides not to make media inventory available to us, or decides to demand a higher revenue share or places significant restrictions on the use of such inventory, we may not be able to find advertising inventory from other websites that satisfy our requirements in a timely and cost-effective manner. In addition, the number of competing online marketing service providers and advertisers that acquire inventory from websites continues to increase. Consolidation of Internet advertising networks and website publishers could eventually lead to a concentration of desirable inventory on websites or networks owned by a small number of individuals or entities, which could limit the supply of inventory available to us or increase the price of inventory to us. For example, throughout fiscal year 2012, our revenue has declined in our financial services client vertical primarily due to volume declines caused by losses of traffic from third-party publishers, which resulted from acquisitions of media sources by competitors, changes in a search engine's algorithms which reduced or eliminated traffic from some third-party publishers, and increased competition for quality media. We cannot assure you that we will be able to acquire advertising inventory that meets our clients' performance, price and quality requirements, in which case our revenue could decline or our operating costs could increase.

## **Table of Contents**

*Our operating results have fluctuated in the past and may do so in the future, which makes our results of operations difficult to predict and could cause our operating results to fall short of analysts' and investors' expectations.*

Historically, our prior quarterly and annual operating results have fluctuated due to changes in our business, our industry and the general economic climate. Similarly, our future operating results may vary significantly from quarter to quarter due to a variety of factors, many of which are beyond our control. We expect our results to continue to fluctuate for the foreseeable future. Our fluctuating results could cause our performance to be below the expectations of securities analysts and investors, causing the price of our common stock to fall. Because our business is changing and evolving, our historical operating results may not be useful to you in predicting our future operating results. Factors that may increase the volatility of our operating results include the following:

changes in demand and pricing for our services;

changes in our pricing policies, the pricing policies of our competitors, or the pricing of Internet advertising or media;

the addition of new clients or the loss of existing clients;

changes in our clients' advertising agencies or the marketing strategies our clients or their advertising agencies employ;

changes in the regulatory environment for us or our clients;

changes in the economic prospects of our clients or the economy generally, which could alter current or prospective clients' spending priorities, or could increase the time or costs required to complete sales with clients;

changes in the availability of Internet advertising or the cost to reach Internet visitors;

changes in the placement of our websites on search engines;

the introduction of new product or service offerings by our competitors; and

costs related to acquisitions of businesses or technologies.

*We depend upon Internet search companies to attract a significant portion of the visitors to our websites, and any change in the search companies' search algorithms or perception of us or our industry could result in our websites being listed less prominently in either paid or algorithmic search result listings, in which case the number of visitors to our websites and our revenue could decline.*

We depend in significant part on various Internet search companies, such as Google, Microsoft and Yahoo!, and other search websites to direct a significant number of visitors to our websites so that we can provide our online marketing services to our clients. Search websites typically provide two types of search results, algorithmic and paid listings. Algorithmic, or organic, listings are determined and displayed solely by a set of formulas designed by search companies. Paid listings can be purchased and then are displayed if particular words are included in a user's Internet search. Placement in paid listings is generally not determined solely on the bid price, but also takes into account the search engines' assessment of the quality of the website featured in the paid listing and other factors. We rely on both algorithmic and paid search results, as well as advertising on other websites, to direct a substantial share of the visitors to our websites.

## Edgar Filing: QUINSTREET, INC - Form 10-Q

Our ability to maintain the number of visitors to our websites from search websites and other websites is not entirely within our control. For example, Internet search websites frequently revise their algorithms in an attempt to optimize their search result listings or to maintain their internal standards and strategies. Changes in the algorithms could cause our websites to receive less favorable placements, which could reduce the number of users who visit our websites. We have experienced fluctuations in the search result rankings for a number of our websites. For example, some of our sites and paid listing campaigns have been negatively impacted by Google algorithmic changes. In addition, our business model may be deemed similar to those of our competitors and others in our industry that Internet search websites may consider to be unsuitable or unattractive. Internet search websites could deem our content to be unsuitable or below standards or less attractive or worthy than those of other or competing websites. In either case, our websites may receive less favorable placement in algorithmic or paid listings, or both, which would reduce the number of visitors to our sites and have a detrimental effect on our ability to generate revenue.

In addition, we may make decisions that are suboptimal regarding the purchase of paid listings or our proprietary bid management technologies may contain defects or otherwise fail to achieve their intended results, either of which could also reduce the number of visitors to our websites or cause us to incur additional costs. We may also make decisions that are suboptimal regarding the placement of advertisements on other websites and pricing, which could increase our costs to attract such visitors or cause us to incur unnecessary costs. A reduction in the number of visitors to our websites could negatively affect our ability to earn revenue. If visits to our websites decrease, we may need to resort to more costly sources to replace lost visitors, and such increased expense could adversely affect our business and profitability.

---

## **Table of Contents**

***If we are unable to retain the members of our management team or attract and retain qualified management team members in the future, our business and growth could suffer.***

Our success and future growth depend, to a significant degree, on the continued contributions of the members of our management team. Each member of our management team is an at-will employee and may voluntarily terminate his or her employment with us at any time. We also may need to hire additional management team members to adequately manage our business. We may not be able to retain or identify and attract additional qualified management team members. Competition for experienced management-level personnel in our industry is intense. Qualified individuals are in high demand, particularly in the Internet marketing industry, and we may incur significant costs to attract and retain them. Members of our management team have also become, or will soon become, substantially vested in their stock option grants. In addition, we have recently experienced declines in our business and a depressed stock price, making our equity and cash incentive compensation programs less attractive to current and potential members of management. We have recently experienced the loss of several senior members of our management team. If we lose the services of additional members of our management team or if we are unable to attract and retain additional qualified senior managers, our business and growth could suffer.

***We need to hire and retain additional qualified personnel to grow and manage our business. If we are unable to attract and retain qualified personnel, our business and growth could be seriously harmed.***

Our performance depends on the talents and efforts of our employees. Our future success will depend on our ability to attract, retain and motivate highly skilled personnel in all areas of our organization and, in particular, in our engineering/technology, sales and marketing, media, finance and legal/regulatory teams. We have found it difficult from time to time to locate and hire and sometimes retain suitable personnel. If we experience similar difficulties in the future, our growth may be hindered. Qualified individuals are in high demand, particularly in the Internet marketing industry, and we may incur significant costs to attract and retain them. Many of our employees have also become, or will soon become, substantially vested in their stock option grants and may be more likely to leave us as a result. In addition, we have recently experienced declines in our business and a depressed stock price, making our equity and cash incentive compensation programs less attractive to current and potential employees. If we are unable to attract and retain the personnel we need to succeed, our business and growth could be harmed.

***A substantial portion of our revenue is generated from a limited number of clients and, if we lose a major client, our revenue will decrease and our business and prospects would be adversely impacted.***

A substantial portion of our revenue is generated from a limited number of clients. Our top three clients accounted for 16% of our net revenue for the three months ended September 30, 2012. Our clients can generally terminate their contracts with us at any time, with limited prior notice or penalty. Our clients may also reduce their level of business with us, leading to lower revenue. In addition, reductions in business by one or more significant clients may lead to price reductions to our other clients for those products whose prices are determined in whole or in part by client bidding or competition, resulting in lower revenue. We expect that a limited number of clients will continue to account for a significant percentage of our revenue, and the loss of any one of these clients, or material reduction in their marketing spending with us, could decrease our revenue and harm our business.

***We rely on certain advertising agencies for the purchase of various advertising and marketing services on behalf of their clients. Such agencies may have or develop high-risk credit profiles which may result in credit risk to us.***

A portion of our client business is sourced through advertising agencies and, in many cases, we contract with these agencies and not directly with the underlying client. Contracting with these agencies, which in certain cases have or may develop high-risk credit profiles, subjects us to greater credit risk than where we contract with clients directly. This credit risk may vary depending on the nature of an agency's aggregated client base. For the fiscal year ended June 30, 2012, we wrote off an account receivable as a bad debt of approximately \$1.4 million from an advertising agency which became insolvent. There can be no assurances that we will not experience similar bad debt in the future. Any such write-offs could have a materially negative effect on our results of operations for the periods in which the write-offs occur.

***If we fail to compete effectively against other online marketing and media companies and other competitors, we could lose clients and our revenue may decline.***

The market for online marketing is intensely competitive, and we expect this competition to continue to increase in the future both from existing competitors and, given the relatively low barriers to entry into the market, from new competitors. We compete both for clients and for limited high quality advertising inventory. We compete for clients on the basis of a number of factors, including return on marketing expenditures, price and client service.



## Table of Contents

We compete with Internet and traditional media companies for a share of clients' overall marketing budgets, including:

online marketing or media services providers such as Halyard Education Partners in the education client vertical and BankRate in the financial services client vertical;

offline and online advertising agencies;

major Internet portals and search engine companies with advertising networks such as Google, Yahoo!, and Microsoft;

other online marketing service providers, including online affiliate advertising networks and industry-specific portals or lead generation companies;

website publishers with their own sales forces that sell their online marketing services directly to clients;

in-house marketing groups and activities at current or potential clients;

offline direct marketing agencies;

mobile and social media; and

television, radio and print companies.

Competition for web traffic among websites and search engines, as well as competition with traditional media companies, could result in significant price pressure, declining margins, reductions in revenue and loss of market share. In addition, if we expand the scope of our services, we may compete with a greater number of websites, clients and traditional media companies across an increasing range of different services, including in vertical markets where competitors may have advantages in expertise, brand recognition and other areas. Large Internet companies with brand recognition, such as Google, Yahoo!, and Microsoft, have significant numbers of direct sales personnel and substantial proprietary advertising inventory and web traffic that provide a significant competitive advantage and have significant impact on pricing for Internet advertising and web traffic. These companies may also develop more vertically targeted products that match consumers with products and services, such as Google's mortgage rate and credit card comparison products, and, thus, compete with us more directly. The trend toward consolidation in the Internet advertising arena may also affect pricing and availability of advertising inventory and web traffic. Many of our current and potential competitors also enjoy other competitive advantages over us, such as longer operating histories, greater brand recognition, larger client bases, greater access to advertising inventory on high-traffic websites, and significantly greater financial, technical and marketing resources. As a result, we may not be able to compete successfully. Competition from other marketing service providers' online and offline offerings could affect both volume and price, and, thus, revenue. If we fail to deliver results that are superior to those that other online marketing service providers deliver to clients, we could lose clients and our revenue may decline.

***We have a significant amount of debt, which may limit our ability to fund general corporate requirements and obtain additional financing, limit our flexibility in responding to business opportunities and competitive developments and increase our vulnerability to adverse economic and industry conditions.***

As of September 30, 2012, we had an outstanding term loan with a principal balance of \$96.3 million and a \$200 million revolving credit line, all of which is available to be drawn, subject to compliance with applicable covenants. As of such date, we also had outstanding notes to sellers arising from numerous acquisitions in the total principal amount of \$9.0 million. As a result of obligations associated with our debt:

we may not have sufficient liquidity to respond to business opportunities, competitive developments and adverse economic conditions;



---

**Table of Contents**

we may not have sufficient liquidity to fund all of our costs if our revenue declines or costs increase; and

we may not have sufficient funds to repay the principal balance of our debt when due.

Our debt obligations may also impair our ability to obtain additional financing, if needed. Our indebtedness is secured by substantially all of our assets, leaving us with limited collateral for additional financing. Moreover, the terms of our indebtedness restrict our ability to take certain actions, including the incurrence of additional indebtedness, certain mergers and acquisitions, investments, asset sales and stock repurchases. In addition, even if we are able to raise needed equity financing, we are required to use a portion of the net proceeds of certain types of equity financings to repay the outstanding balance of our term loan. A failure to pay interest or indebtedness when due could result in a variety of adverse consequences, including the acceleration of our indebtedness. In such a situation, it is unlikely that we would be able to fulfill our obligations under our credit facility or repay the accelerated indebtedness or otherwise cover our costs.

***The continued global macroeconomic uncertainty poses additional risks to our business, financial condition and results of operations.***

The United States and the global economy are experiencing a prolonged period of economic uncertainty following severe economic downturns and credit issues in many countries. The slow pace of recovery in the United States, deterioration of global economies, potential insolvency of one or more countries globally, high unemployment and reduced and/or volatile equity valuations all create risks that have harmed and may continue to harm our business. If macroeconomic conditions do not improve or if they worsen, we are not able to predict the impact such continued or worsening conditions will have on the online marketing industry in general, and our results of operations specifically. Clients in particular client verticals such as financial services, particularly mortgage, credit cards and deposits, small- and medium-sized business customers and home services are facing very difficult conditions and their marketing spend has been negatively affected. These conditions have damaged and may continue to damage our business opportunities in existing markets, and reduce our revenue and profitability. While the effect of these and related conditions poses widespread risk across our business, we believe that it may particularly affect our efforts in the mortgage, credit cards and deposits, small- and medium-sized business and home services client verticals, due to reduced availability of credit for households and businesses and reduced household disposable income.

***Poor perception of our business or industry as a result of the actions of third parties could harm our reputation and adversely affect our business, financial condition and results of operations.***

Our business is dependent on attracting a large number of visitors to our websites and providing leads and clicks to our clients, which depends in part on our reputation within the industry and with our clients. There are companies within our industry that regularly engage in activities that others may view as unlawful or inappropriate. These activities by third parties, such as spyware or deceptive promotions, may be seen as characteristic of participants in our industry and, therefore, may have an adverse effect on the reputation of all participants in our industry, including us. Negative perceptions of our business may result in incremental regulation, enforcement actions by the government and increased litigation, any of which may affect our business and result in lower revenue. Any damage to our reputation, including from publicity from legal proceedings against us or companies that work within our industry, governmental proceedings, consumer class action litigation, or the disclosure of information security breaches or private information misuse, could adversely affect our business, financial condition and results of operations.

***Our quarterly revenue and operating results may fluctuate significantly from quarter to quarter due to seasonal fluctuations in advertising spending.***

In addition to other factors that cause our operating results to fluctuate, results are also subject to significant fluctuation as a result of seasonality. In particular, our quarters ending December 31 (our second fiscal quarter) generally demonstrate seasonal weakness. In our second fiscal quarters, there is generally lower availability of some forms of media during the holiday period on a cost effective basis and some of our clients request fewer leads due to holiday staffing. Our fluctuating results could cause our performance to be below the expectations of securities analysts and investors, causing the price of our common stock to fall. To the extent our revenue contracts, we expect that the seasonality in our business may become more apparent and may in the future cause our operating results to fluctuate to a greater extent.

## **Table of Contents**

*If we do not effectively manage future growth, our operating performance will suffer and we may lose clients.*

Although we are currently experiencing challenges in growing our business, historically, we have experienced rapid growth in our operations and operating locations. This growth placed, and if we return to growth, will continue to place, significant demands on our management and our operational and financial infrastructure. In addition, we have acquired, and may continue to acquire, the assets of complementary businesses as part of our strategy to expand our portfolio of targeted media on a cost effective basis. Rapid growth and acquisitions may make it more difficult for us to accomplish the following:

successfully scale our technology to accommodate a larger business and integrate acquisitions;

maintain our standing with key vendors, including Internet search companies and third-party website publishers;

maintain our client service standards; and

develop and improve our operational, financial and management controls and maintain adequate reporting systems and procedures. In addition, our personnel, systems, procedures and controls may be inadequate to support our future operations. The improvements required to manage such growth would require us to make significant expenditures, expand, train and manage our employee base and allocate valuable management resources. If we fail to effectively manage future growth or acquisitions, our operating performance will suffer, and we may lose clients, key vendors and key personnel.

***Our future growth depends in part on our ability to identify and complete acquisitions. Any acquisitions that we pursue or complete will involve a number of risks. If we are unable to address and resolve these risks successfully, such acquisition activity could harm our business, results of operations and financial condition.***

Our historical growth has been in significant part due to the large number of acquisitions we have completed of third-party website publishing businesses and other businesses that are complementary to our own. We intend to evaluate and pursue additional acquisitions of complementary businesses and technologies to expand our capabilities, client base and media. We have also evaluated, and expect to continue to evaluate, a wide array of potential strategic transactions. However, we may not be successful in identifying suitable acquisition candidates or be able to complete acquisitions of such candidates. In addition, we may not be able to obtain financing on favorable terms, or at all, to fund acquisitions that we may wish to pursue. The anticipated benefit of acquisitions that we complete may not materialize and the process of integrating acquired businesses or technologies may create unforeseen operating difficulties and expenditures. Some of the areas where we may face acquisition-related risks include:

diversion of management time and potential business disruptions;

difficulties integrating and supporting acquired products or technologies;

disruptions or reductions in client revenue associated with changes to the business models of acquired businesses;

expenses, distractions and potential claims resulting from acquisitions, whether or not they are completed;

retaining and integrating employees from any businesses we may acquire;

issuance of dilutive equity securities, incurrence of debt or reduction in cash balances;

integrating various accounting, management, information, human resource and other systems to permit effective management;

incurring possible impairment charges, contingent liabilities, amortization expense or write-offs of goodwill;

unexpected capital expenditure requirements;

insufficient incremental revenue to offset increased expenses associated with acquisitions;

## **Table of Contents**

underperformance of acquired businesses or assets; and

becoming involved in acquisition-related litigation.

Foreign acquisitions involve risks in addition to those mentioned above, including those related to integration of operations across different cultures and languages, currency risks and the particular economic, political, administrative and management, and regulatory risks associated with specific countries. We may not be able to address these risks successfully, or at all, without incurring significant costs, delay or other operating problems. Our inability to resolve such risks could harm our business and results of operations.

***We may need additional capital in the future to meet our financial obligations and to pursue our business objectives. Additional capital may not be available or may not be available on favorable terms and our business and financial condition could therefore be adversely affected.***

While we anticipate that our existing cash and cash equivalents, together with availability under our credit facility and cash from operations, will be sufficient to fund our operations for at least the next 12 months, we may need to raise additional capital to fund operations in the future or to finance acquisitions. If we seek to raise additional capital in order to meet various objectives, including developing future technologies and services, increasing working capital, acquiring businesses and responding to competitive pressures, capital may not be available on favorable terms or may not be available at all. In addition, pursuant to the terms of our credit facility, we are required to use a portion of the net proceeds of certain equity financings to repay the outstanding balance of our term loan. Lack of sufficient capital resources could significantly limit our ability to take advantage of business and strategic opportunities. Any additional capital raised through the sale of equity or debt securities with an equity component would dilute our stock ownership. If adequate additional funds are not available, we may be required to delay, reduce the scope of, or eliminate material parts of our business strategy, including potential additional acquisitions or development of new technologies.

***If the market for online marketing services fails to continue to develop, our future growth may be limited and our revenue may decrease.***

The online marketing services market is relatively new and rapidly evolving, and it uses different measurements than traditional media to gauge its effectiveness. Some of our current or potential clients have little or no experience using the Internet for advertising and marketing purposes and have allocated only limited portions of their advertising and marketing budgets to the Internet. The adoption of Internet advertising, particularly by those entities that have historically relied upon traditional media for advertising, requires the acceptance of a new way of conducting business, exchanging information and evaluating new advertising and marketing technologies and services. In particular, we are dependent on our clients' adoption of new metrics to measure the success of online marketing campaigns. We may also experience resistance from traditional advertising agencies who may be advising our clients. We cannot assure you that the market for online marketing services will continue to grow. If the market for online marketing services fails to continue to develop or develops more slowly than we anticipate, our ability to grow our business may be limited and our revenue may decrease.

***Third-party website publishers may engage in unauthorized or unlawful acts that could subject us to significant liability or cause us to lose clients.***

We generate a significant portion of our web visitors from media advertising that we purchase from third-party website publishers. Some of these publishers are authorized to display our clients' brands, subject to contractual restrictions. In the past, some of our third-party website publishers have engaged in activities that certain of our clients have viewed as harmful to their brands, such as displaying outdated descriptions of a client's offerings or outdated logos. Any activity by publishers that clients view as potentially damaging to their brands can harm our relationship with the client and cause the client to terminate its relationship with us, resulting in a loss of revenue. In addition, the law is unsettled on the extent of liability that an advertiser in our position has for the activities of third-party website publishers. Recent Department of Education regulations impose strict liability on our education clients for misrepresentations made by their marketing service providers and many of our contracts in the education client vertical impose liability on us for the acts of our third-party publishers. We could be subject to costly litigation and, if we are unsuccessful in defending ourselves, damages for the unauthorized or unlawful acts of third-party website publishers.

---

## **Table of Contents**

***Because many of our client contracts can be cancelled by the client with little or no prior notice or penalty, the cancellation of one or more contracts could result in an immediate decline in our revenue.***

We derive our revenue from contracts with our Internet marketing clients, most of which are cancelable with little or no prior notice. In addition, these contracts do not contain penalty provisions for cancellation before the end of the contract term. The non-renewal, renegotiation, cancellation, or deferral of large contracts, or a number of contracts that in the aggregate account for a significant amount of our revenue, is difficult to anticipate and could result in an immediate decline in our revenue.

***Unauthorized access to or accidental disclosure of consumer personally-identifiable information that we collect may cause us to incur significant expenses and may negatively affect our credibility and business.***

There is growing concern over the security of personal information transmitted over the Internet, consumer identity theft and user privacy. Despite our implementation of security measures, our computer systems may be susceptible to electronic or physical computer break-ins, viruses and other disruptions and security breaches. Any perceived or actual unauthorized disclosure of personally-identifiable information regarding website visitors, whether through breach of our network by an unauthorized party, employee theft, misuse or error or otherwise, could harm our reputation, impair our ability to attract website visitors and attract and retain our clients, or subject us to claims or litigation arising from damages suffered by consumers, and thereby harm our business and operating results. In addition, we could incur significant costs in complying with the multitude of state, federal and foreign laws regarding the unauthorized disclosure of personal information.

***If we do not adequately protect our intellectual property rights, our competitive position and business may suffer.***

Our ability to compete effectively depends upon our proprietary systems and technology. We rely on trade secret, trademark and copyright law, confidentiality agreements, and technical measures to protect our proprietary rights. We currently have two patent applications pending in the United States and no issued patents. Effective trade secret, copyright, trademark and patent protection may not be available in all countries where we currently operate or in which we may operate in the future. Some of our systems and technologies are not covered by any copyright, patent or patent application. We cannot guarantee that: (i) our intellectual property rights will provide competitive advantages to us; (ii) our ability to assert our intellectual property rights against potential competitors or to settle current or future disputes will be effective; (iii) our intellectual property rights will be enforced in jurisdictions where competition may be intense or where legal protection may be weak; (iv) any of the trademarks, copyrights, trade secrets or other intellectual property rights that we presently employ in our business will not lapse or be invalidated, circumvented, challenged, or abandoned; (v) competitors will not design around our protected systems and technology; or (vi) that we will not lose the ability to assert our intellectual property rights against others.

We are a party to a number of third-party intellectual property license agreements and in the future may need to obtain additional licenses or renew existing license agreements. We are unable to predict with certainty whether these license agreements can be obtained or renewed on commercially reasonable terms, or at all.

We have from time to time become aware of third parties who we believe may have infringed on our intellectual property rights. The use of our intellectual property rights by others could reduce any competitive advantage we have developed and cause us to lose clients, third-party website publishers or otherwise harm our business. Policing unauthorized use of our proprietary rights can be difficult and costly. In addition, litigation, while it may be necessary to enforce or protect our intellectual property rights or to defend litigation brought against us, could result in substantial costs and diversion of resources and management attention and could adversely affect our business, even if we are successful on the merits.

***Confidentiality agreements with employees, consultants and others may not adequately prevent disclosure of trade secrets and other proprietary information.***

We have devoted substantial resources to the development of our proprietary systems and technology. In order to protect our proprietary systems and technology, we enter into confidentiality agreements with our employees, consultants, independent contractors and other advisors. These agreements may not effectively prevent unauthorized disclosure of confidential information or unauthorized parties from copying aspects of our services or obtaining and using information that we regard as proprietary. Moreover, these agreements may not provide an adequate remedy in the event of such unauthorized disclosures of confidential information and we cannot assure you that our rights under such agreements will be enforceable. In addition, others may independently discover trade secrets and proprietary information, and in such cases we could not assert any trade secret rights against such parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could reduce any competitive advantage we have and cause us to lose clients, publishers or otherwise harm our business.



---

**Table of Contents**

*Third parties may sue us for intellectual property infringement which, if successful, could require us to pay significant damages or curtail our offerings.*

We cannot be certain that our internally-developed or acquired systems and technologies do not and will not infringe the intellectual property rights of others. In addition, we license content, software and other intellectual property rights from third parties and may be subject to claims of infringement if such parties do not possess the necessary intellectual property rights to the products they license to us. For example, we are currently defending a patent infringement action brought against us by LendingTree. While we believe that we have meritorious defenses against LendingTree's claims, there can be no assurance that we will prevail in this matter and any adverse ruling may have a significant impact on our business and operating results. In addition, regardless of the outcome of the matter, we may incur significant legal fees defending or settling the action.

In addition, we have in the past and may in the future be subject to legal proceedings and claims that we have infringed the patent or other intellectual property rights of third-parties. These claims sometimes involve patent holding companies or other adverse patent owners who have no relevant product revenue and against whom our own patents, if any, may therefore provide little or no deterrence. In addition, third parties have asserted and may in the future assert intellectual property infringement claims against our clients, which we have agreed in certain circumstances to indemnify and defend against such claims. Any intellectual property related infringement claims, whether or not meritorious, could result in costly litigation and could divert management resources and attention. Moreover, should we be found liable for infringement, we may be required to enter into licensing agreements, if available on acceptable terms or at all, pay substantial damages, or limit or curtail our systems and technologies. Moreover, we may need to redesign some of our systems and technologies to avoid future infringement liability. Any of the foregoing could prevent us from competing effectively and increase our costs.

Additionally, the laws relating to use of trademarks on the Internet are currently unsettled, particularly as they apply to search engine functionality. For example, other Internet marketing and search companies have been sued in the past for trademark infringement and other intellectual property-related claims for the display of ads or search results in response to user queries that include trademarked terms. The outcomes of these lawsuits have differed from jurisdiction to jurisdiction. For this reason, it is conceivable that certain of our activities could expose us to trademark infringement, unfair competition, misappropriation or other intellectual property related claims which could be costly to defend and result in substantial damages or otherwise limit or curtail our activities, and adversely affect our business or prospects.

*If we fail to keep pace with rapidly-changing technologies and industry standards or if our technologies fail to perform as intended, we could lose clients or advertising inventory, and our results of operations may suffer.*

The industry in which we compete is characterized by rapidly-changing Internet media and marketing standards, changing technologies, frequent new product and service introductions, and changing user and client demands. The introduction of new technologies and services embodying new technologies and the emergence of new industry standards and practices could render our existing technologies and services obsolete and unmarketable or require unanticipated investments in technology. Our future success will depend in part on our ability to adapt to these rapidly-changing Internet media formats and other technologies. We will need to enhance our existing technologies and services and develop and introduce new technologies and services to address our clients' changing demands. If we fail to adapt successfully to such developments or timely introduce new technologies and services, we could lose clients, our expenses could increase, and we could lose advertising inventory.

In addition, our proprietary technologies are relatively new and evolve quickly and they may contain design or performance defects that are not readily apparent. The use of our proprietary technologies may not achieve the intended results as effectively as other technologies that exist now or may be introduced by our competitors, in which case our business could be harmed.

*Changes in government regulation and industry standards applicable to the Internet and our business could decrease demand for our technologies and services or increase our costs.*

Laws and regulations that apply to Internet communications, commerce and advertising are becoming more prevalent. These regulations could increase the costs of conducting business on the Internet and could decrease demand for our technologies and services.

---

**Table of Contents**

In the United States, federal and state laws have been enacted regarding copyrights, sending of unsolicited commercial email, user privacy, search engines, Internet tracking technologies, direct marketing, data security, children's privacy, pricing, sweepstakes, promotions, intellectual property ownership and infringement, trade secrets, export of encryption technology, taxation and acceptable content and quality of goods. Other laws and regulations may be adopted in the future. Laws and regulations, including those related to privacy and use of personal information, are changing rapidly outside the United States as well which may make compliance with such laws and regulations difficult and which may negatively affect our ability to expand internationally. This legislation could: (i) hinder growth in the use of the Internet generally; (ii) decrease the acceptance of the Internet as a communications, commercial and advertising medium; (iii) reduce our revenue; (iv) increase our operating expenses; or (v) expose us to significant liabilities.

The laws governing the Internet remain largely unsettled, even in areas where there has been some legislative action. While we actively monitor this changing legal and regulatory landscape to stay abreast of changes in the laws and regulations applicable to our business, we are not certain how our business might be affected by the application of existing laws governing issues such as property ownership, copyrights, encryption and other intellectual property issues, libel, obscenity and export or import matters to the Internet advertising industry. The vast majority of such laws were adopted prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes in laws intended to address such issues could create uncertainty in the Internet market. It may take years to determine how existing laws apply to the Internet and Internet marketing. Such uncertainty makes it difficult to predict costs and could reduce demand for our services or increase the cost of doing business as a result of litigation costs or increased service delivery costs.

In particular, a number of U.S. federal laws impact our business. The Digital Millennium Copyright Act, or DMCA, is intended, in part, to limit the liability of eligible online service providers for listing or linking to third-party websites that include materials that infringe copyrights or other rights. Portions of the Communications Decency Act, or CDA, are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business.

In addition, the Federal Communications Commission recently amended its regulations under the Telephone Consumer Protection Act (TCPA), effective in July 2012, which could increase our exposure to liability for certain types of telephonic communication with customers, including calls made by our call centers and text messages to mobile phones. Under the TCPA, plaintiffs may seek actual monetary loss or statutory damages of \$500 per violation, whichever is greater, and courts may treble the damage award for willful or knowing violations. If we were subject to litigation for violation of TCPA, we could be exposed to significant damage awards that could, individually or in the aggregate, materially harm our business.

The U.S. Department of Education issued regulations on incentive compensation and other matters which became effective July 1, 2011. These regulations repeal all safe harbors regarding incentive compensation which existed under the prior regulations. The elimination of the safe harbors create uncertainty for us and our education clients and impact the way in which we are paid by our clients and, accordingly, could reduce the amount of revenue we generate from the education client vertical.

The Department of Education has also issued regulations that restrict Title IV funding for programs not meeting prescribed income-to-debt ratios (i.e., programs not leading to gainful employment as defined under the proposed regulation). These provisions, could negatively affect our business with education clients. Any changes in these laws or judicial interpretations narrowing their protections could subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business.

The financial services, education and medical industries are highly regulated and our marketing activities on behalf of our clients in those industries are also regulated. As described above, and for example, the regulations from the Department of Education on incentive compensation, gainful employment and other matters could limit our clients' businesses and limit the revenue we receive from our education clients. As an additional example, our mortgage and insurance websites and marketing services we offer are subject to various federal, state and local laws, including state licensing laws, federal and state laws prohibiting unfair acts and practices, and federal and state advertising laws. Any failure to comply with these laws and regulations could subject us to revocation of required licenses, civil, criminal or administrative liability, damage to our reputation or changes to or limitations on the conduct of our business. Any of the foregoing could cause our business, operations and financial condition to suffer.



**Table of Contents**

***If any regulatory audit, investigation or other proceeding finds us not in compliance with the numerous laws and regulations applicable to us, we may not be able to successfully challenge such finding, and our business could suffer.***

We are subject to audits, inquiries, investigations, claims of non-compliance and lawsuits by federal and state governmental agencies, regulatory agencies, attorneys general and other governmental or regulatory bodies, any of whom may allege violations of the legal or regulatory requirements applicable to us. For example, we responded to a civil investigation conducted by the attorneys general of Alabama, Arizona, Delaware, Florida, Idaho, Illinois, Iowa, Kentucky, Massachusetts, Minnesota, Nevada, North Carolina, Oregon, South Carolina, and Tennessee into certain of our marketing and business practices related to our education client vertical during fiscal year 2012. On June 26, 2012, we entered into an Assurance of Voluntary Compliance agreement (the Agreement) with the attorneys general which required us to transfer the GIBill.com website to the United States Veterans Administration, to pay \$2.5 million to the settling states and to add disclosures and disclaimers to our education-related websites. The new disclosures and disclaimers required by the Agreement could negatively affect media conversion rates and, thus, our revenue or profitability. If the results of future audits, inquiries, investigations, claims and lawsuits are unfavorable to us, we may be required to pay monetary fines or penalties or have restrictions placed on our business. Any one of these sanctions could materially adversely affect our business, financial condition, results of operations and cash flows and result in the imposition of significant restrictions on us and our ability to operate.

***Increased taxation of companies engaged in Internet commerce may adversely affect the commercial use of our marketing services and our financial results.***

The tax treatment of Internet commerce remains unsettled, and we cannot predict the effect of current attempts to impose sales, income or other taxes on commerce conducted over the Internet. Tax authorities at the international, federal, state and local levels are currently reviewing the taxation of Internet commerce, particularly as many governmental agencies seek to address fiscal concerns and budgetary shortfalls by introducing new taxes or expanding the applicability of existing tax laws. We have experienced certain states taking expansive positions with regard to their taxation of our services. The imposition of new laws requiring the collection of sales or other transactional taxes on the sale of our services via the Internet could create increased administrative burdens or costs, discourage clients from purchasing services from us, decrease our ability to compete or otherwise substantially harm our business and results of operations.

***Limitations on our ability to collect and use data derived from user activities could significantly diminish the value of our services and cause us to lose clients and revenue.***

When a user visits our websites, we use technologies, including cookies, to collect information such as the user's Internet Protocol, or IP, address, offerings delivered by us that have been previously viewed by the user and responses by the user to those offerings. We access and analyze this information in order to determine the effectiveness of a marketing campaign and to determine how to modify the campaign. The use of cookies is the subject of regulatory scrutiny and industry self-regulatory activities, including the discussion of do-not-track technologies and guidelines and to litigation. The European Union recently passed new data laws relating to the collection and misuse of personal information, including restrictions on the use of Internet tracking tools, or cookies. These new regulations or any similar regulation that is adopted in the U.S. could negatively impact the manner in which we use cookies and require us to incur additional costs or change our business practices, any of which could harm our business. Additionally, users are able to block or delete cookies from their browser. Periodically, certain of our clients and publishers seek to prohibit or limit our collection or use of this data. Interruptions, failures or defects in our data collection systems, as well as privacy concerns regarding the collection of user data, could also limit our ability to analyze data from our clients' marketing campaigns. This risk is heightened when we deliver marketing services to clients in the financial and medical services client verticals. If our access to data is limited in the future, we may be unable to provide effective technologies and services to clients and we may lose clients and revenue.

***As a creator and a distributor of Internet content, we face potential liability and expenses for legal claims based on the nature and content of the materials that we create or distribute. If we are required to pay damages or expenses in connection with these legal claims, our operating results and business may be harmed.***

We create original content for our websites and marketing messages and distribute third-party content on our websites and in our marketing messages. As a creator and distributor of original content and third-party provided content, we face potential liability based on a variety of theories, including defamation, negligence, deceptive advertising (including the Department of Education's regulations regarding misrepresentation in education marketing), copyright or trademark infringement or other legal theories based on the nature, creation or distribution of this information. It is also possible that our website visitors could make claims against us for

## **Table of Contents**

losses incurred in reliance upon information provided on our websites. We could also be exposed to liability in connection with material posted to our websites by users and other third parties. These claims, whether brought in the United States or abroad, could divert management time and attention away from our business and result in significant costs to investigate and defend, regardless of the merit of these claims. In addition, if we become subject to these types of claims and are not successful in our defense, we may be forced to pay substantial damages.

***Wireless devices and mobile phones are increasingly being used to access the Internet, and our online marketing services may not be as effective when accessed through these devices, which could cause harm to our business.***

The number of people who access the Internet through mobile devices such as smartphones and tablets has increased substantially in the last few years. Our online marketing services were designed for persons accessing the Internet on a desktop or laptop computer. The smaller screens, lower resolution graphics and less convenient typing capabilities of these devices may make it more difficult for visitors to respond to our offerings. In addition, the cost of mobile advertising is relatively high and may not be cost-effective for our services. If our services continue to be less effective or economically attractive for clients seeking to engage in marketing through these devices and this segment of web traffic grows at the expense of traditional computer Internet access, we will experience difficulty attracting website visitors and attracting and retaining clients, and our operating results and business will be harmed.

***We may not succeed in expanding our businesses outside the United States, which may limit our future growth. We face additional risks in conducting business in international markets.***

One potential area of growth for us is in the international markets, and we have recently entered into certain international markets. We have limited experience in marketing, selling and supporting our services outside of the United States, and we may not be successful in introducing or marketing our services abroad.

There are risks inherent in conducting business in international markets, such as:

the adaptation of technologies and services to foreign clients' preferences and customs;

application of foreign laws and regulations to us, including marketing and privacy regulations;

changes in foreign political and economic conditions;

tariffs and other trade barriers, fluctuations in currency exchange rates and potentially adverse tax consequences;

language barriers or cultural differences;

reduced or limited protection for intellectual property rights in foreign jurisdictions;

difficulties and costs in staffing, managing or overseeing foreign operations;

education of potential clients who may not be familiar with online marketing;

challenges in collecting accounts receivables; and

employment regulations and local labor conditions.

If we are unable to successfully expand and market our services abroad, our business and future growth may be harmed, and we may incur costs that may not lead to future revenue.

***We could be adversely affected by violations of the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws.***

The U.S. Foreign Corrupt Practices Act ( FCPA ) and similar worldwide anti-bribery laws generally prohibit companies and their intermediaries from making improper payments to non-U.S. government officials for the purpose of obtaining or retaining business. We operate in parts of the world outside the United States, including India, Brazil and Mexico, that have experienced

**Table of Contents**

governmental corruption to some degree. There can be no assurance that our internal control policies and procedures will always protect us from reckless or criminal acts committed by our employees or agents. Violations of these laws, or allegations of such violations, could disrupt our business and result in a material adverse effect on our results of operations, financial condition and cash flows.

***We rely on Internet bandwidth and data center providers and other third parties for key aspects of the process of providing services to our clients, and any failure or interruption in the services and products provided by these third parties could harm our business.***

We rely on third-party vendors, including data center and Internet bandwidth providers. Any disruption in the network access or co-location services provided by these third-party providers or any failure of these third-party providers to handle current or higher volumes of use could significantly harm our business. Any financial or other difficulties our providers face may have negative effects on our business, the nature and extent of which we cannot predict. We exercise little control over these third-party vendors, which increases our vulnerability to problems with the services they provide. We license technology and related databases from third parties to facilitate analysis and storage of data and delivery of offerings. We have experienced interruptions and delays in service and availability for data centers, bandwidth and other technologies in the past. Any errors, failures, interruptions or delays experienced in connection with these third-party technologies and services could adversely affect our business and could expose us to liabilities to third parties.

Our systems also heavily depend on the availability of electricity, which also comes from third-party providers. If we or third-party data centers which we utilize were to experience a major power outage, we would have to rely on back-up generators. These back-up generators may not operate properly through a major power outage and their fuel supply could also be inadequate during a major power outage or disruptive event. Furthermore, we do not currently have backup generators at our Foster City, California headquarters. Information systems such as ours may be disrupted by even brief power outages, or by the fluctuations in power resulting from switches to and from back-up generators. This could give rise to obligations to certain of our clients which could have an adverse effect on our results for the period of time in which any disruption of utility services to us occurs.

***Interruption or failure of our information technology and communications systems could impair our ability to effectively deliver our services, which could cause us to lose clients and harm our operating results.***

Our delivery of marketing and media services depends on the continuing operation of our technology infrastructure and systems. Any damage to or failure of our systems could result in interruptions in our ability to deliver offerings quickly and accurately and/or process visitors' responses emanating from our various web presences. Interruptions in our service could reduce our revenue and profits, and our reputation could be damaged if people believe our systems are unreliable. Our systems and operations are vulnerable to damage or interruption from earthquakes, terrorist attacks, floods, fires, power loss, break-ins, hardware or software failures, telecommunications failures, computer viruses or other attempts to harm our systems, and similar events.

We lease or maintain server space in various locations, including in San Francisco, California. Our California facilities are located in areas with a high risk of major earthquakes. Our facilities are also subject to break-ins, sabotage and intentional acts of vandalism, and to potential disruptions if the operators of these facilities have financial difficulties. Some of our systems are not fully redundant, and our disaster recovery planning cannot account for all eventualities. The occurrence of a natural disaster, a decision to close a facility we are using without adequate notice for financial reasons or other unanticipated problems at our facilities could result in lengthy interruptions in our service.

Any unscheduled interruption in our service would result in an immediate loss of revenue. If we experience frequent or persistent system failures, the attractiveness of our technologies and services to clients and website publishers could be permanently harmed. The steps we have taken to increase the reliability and redundancy of our systems are expensive, reduce our operating margin, and may not be successful in reducing the frequency or duration of unscheduled interruptions.

***Any constraints on the capacity of our technology infrastructure could delay the effectiveness of our operations or result in system failures, which would result in the loss of clients and harm our business and results of operations.***

Our future success depends in part on the efficient performance of our software and technology infrastructure. As the numbers of websites and Internet users increase, our technology infrastructure may not be able to meet the increased demand. A sudden and unexpected increase in the volume of user responses could strain the capacity of our technology infrastructure. Any capacity

**Table of Contents**

constraints we experience could lead to slower response times or system failures and adversely affect the availability of websites and the level of user responses received, which could result in the loss of clients or revenue or harm to our business and results of operations.

*We could lose clients if we fail to detect click-through or other fraud on advertisements in a manner that is acceptable to our clients.*

We are exposed to the risk of fraudulent clicks or actions on our websites or our third-party publishers' websites. We may in the future have to refund revenue that our clients have paid to us and that was later attributed to, or suspected to be caused by fraud. Click-through fraud occurs when an individual clicks on an ad displayed on a website or an automated system is used to create such clicks with the intent of generating the revenue share payment to the publisher rather than to view the underlying content. Action fraud occurs when on-line forms are completed with false or fictitious information in an effort to increase the compensable actions in respect of which a web publisher is to be compensated. From time to time, we have experienced fraudulent clicks or actions. We do not charge our clients for fraudulent clicks or actions when they are detected, and such fraudulent activities could negatively affect our profitability or harm our reputation. If fraudulent clicks or actions are not detected, the affected clients may experience a reduced return on their investment in our marketing programs, which could lead the clients to become dissatisfied with our campaigns, and in turn, lead to loss of clients and the related revenue. Additionally, we have, from time to time, had to, and in the future may have to, terminate relationships with web publishers who we believed to have engaged in fraud. Termination of such relationships entails a loss of revenue associated with the legitimate actions or clicks generated by such web publishers.

*An impairment in the carrying value of goodwill and other indefinite-lived intangible assets could negatively affect our operating results.*

We have a substantial amount of goodwill and purchased intangible assets on our balance sheet as a result of acquisitions we have completed. The carrying value of goodwill represents the fair value of an acquired business in excess of identifiable assets and liabilities as of the acquisition date. The carrying value of intangible assets with identifiable useful lives represents the fair value of relationships, content, domain names, acquired technology, among others, as of the acquisition date, and are amortized based on their economic lives. Goodwill expected to contribute indefinitely to our cash flows are not amortized, but must be evaluated for impairment at least annually. If the carrying value exceeds current fair value as determined based on the discounted future cash flows of the related business, the goodwill or intangible asset is considered impaired and is reduced to fair value via a non-cash charge to earnings. Events and conditions that could result in impairment include adverse changes in the regulatory environment, or other factors leading to reduction in expected long-term growth or profitability. If the value of goodwill or intangible assets is impaired, our earnings could be adversely affected.

Goodwill impairment analysis and measurement is a process that requires significant judgment. Our stock price and any estimated control premium are factors impacting the assessment of the fair value of our underlying reporting units for purposes of performing any goodwill impairment assessment. The market price per share of our common stock price fluctuated from a high of \$10.05 to a low of \$8.29 during the first quarter of fiscal year 2013 and to a closing low of \$6.03 subsequent to September 30, 2012 and through the date of this filing. If our stock price becomes further depressed and our market capitalization drops below our book value for a sustained period, then it is possible that this may be an indicator of goodwill impairment. A non-cash goodwill impairment charge would have the effect of decreasing our earnings or increasing our losses in such period. If we are required to take a substantial impairment charge, then our operating results would be materially adversely affected in such period.

*If we fail to maintain proper and effective internal controls, our ability to produce accurate financial statements on a timely basis could be impaired, which would adversely affect our ability to operate our business.*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. We may in the future discover areas of our internal financial and accounting controls and procedures that need improvement. Our internal control over financial reporting will not prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud will be detected. If we are unable to maintain proper and effective internal controls, we may not be able to produce accurate financial statements on a timely basis, which could adversely affect our ability to operate our business and could result in regulatory action.

## Table of Contents

### **Risks Related to the Ownership of Our Common Stock**

*Our stock price may be volatile, and you may not be able to resell shares of our common stock at or above the price you paid.*

The trading price of our common stock has been highly volatile since our initial public offering and may continue to be subject to wide fluctuations in response to various factors, some of which are beyond our control. These factors include those discussed in this Risk Factors section of this report on Form 10-K and others such as:

our ability to manage a return to growth and to manage such growth effectively;

changes in earnings estimates or recommendations by securities analysts;

announcements about our revenues, earnings or growth rates that are not in line with analyst expectations, the risk of which is heightened because it is our policy not to give quarterly guidance on revenue, earnings, or growth rates.

changes in governmental regulations;

announcements regarding stock repurchase programs and the timing and amount of shares we purchase under such programs;

announcements by us or our competitors of new services, significant contracts, commercial relationships, acquisitions or capital commitments;

changes in the search engine rankings of our sites or our ability to access PPC advertising;

developments with respect to intellectual property rights;

our ability to develop and market new and enhanced products on a timely basis;

our commencement of, or involvement in, litigation;

negative publicity about us, our industry, our clients or our clients' industries; and

a slowdown in our industry or the general economy.

In recent years, the stock market in general, and the market for technology and Internet-based companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of our common stock, regardless of our actual operating performance. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company's securities, securities class action litigation has often been instituted against these companies. Such litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

*If securities or industry analysts do not publish research or reports about our business, or if they issue an adverse opinion regarding our stock, our stock price and trading volume could decline.*

The trading market for our common stock is influenced by the research and reports that industry or securities analysts publish about us, our business or the industries or businesses of our clients. If any of the analysts who cover us issue an adverse opinion regarding our stock, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

## **Table of Contents**

### ***Material differences between our results and security analysts' estimates could cause our stock price to decrease.***

Our results may differ materially from security analysts' estimates, either in total or for a specific client vertical and such difference could cause the market price of our stock to decrease.

We have generally not provided specific guidance or forecasts for near-term operating results, increasing the likelihood that analyst estimates could differ from our own expectations and increasing the likelihood that our future results could differ from analyst estimates, either in total or for a specific client vertical.

### ***Our directors and executive officers and their respective affiliates have substantial control over us and could delay or prevent a change in corporate control.***

As of September 30, 2012, our directors and executive officers, together with their affiliates, beneficially owned approximately 34% of our outstanding common stock. As a result, these stockholders, acting together, have substantial control over the outcome of matters submitted to our stockholders for approval, including the election of directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, these stockholders, acting together, have significant influence over the management and affairs of our company. Accordingly, this concentration of ownership may have the effect of:

delaying, deferring or preventing a change in corporate control;

impeding a merger, consolidation, takeover or other business combination involving us; or

discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of us.

### ***Future sales of shares by existing stockholders could cause our stock price to decline.***

If our directors, officers and/or their affiliates were to sell, or indicate an intent to sell, substantial amounts of our common stock held by them, the trading price of our common stock could decline significantly.

### ***Provisions in our charter documents under Delaware law and in contractual obligations, could discourage a takeover that stockholders may consider favorable and may lead to entrenchment of management.***

Our amended and restated certificate of incorporation and bylaws contain provisions that could have the effect of delaying or preventing changes in control or changes in our management without the consent of our board of directors. These provisions include:

a classified board of directors with three-year staggered terms, which may delay the ability of stockholders to change the membership of a majority of our board of directors;

no cumulative voting in the election of directors, which limits the ability of minority stockholders to elect director candidates;

the exclusive right of our board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or the resignation, death or removal of a director, which prevents stockholders from being able to fill vacancies on our board of directors;



## Edgar Filing: QUINSTREET, INC - Form 10-Q

the ability of our board of directors to determine to issue shares of preferred stock and to determine the price and other terms of those shares, including preferences and voting rights, without stockholder approval, which could be used to significantly dilute the ownership of a hostile acquirer;

a prohibition on stockholder action by written consent, which forces stockholder action to be taken at an annual or special meeting of our stockholders;

the requirement that a special meeting of stockholders may be called only by the chairman of the board of directors, the chief executive officer or the board of directors, which may delay the ability of our stockholders to force consideration of a proposal or to take action, including the removal of directors; and

**Table of Contents**

advance notice procedures that stockholders must comply with in order to nominate candidates to our board of directors or to propose matters to be acted upon at a stockholders' meeting, which may discourage or deter a potential acquiror from conducting a solicitation of proxies to elect the acquiror's own slate of directors or otherwise attempting to obtain control of us.

We are subject to certain anti-takeover provisions under Delaware law. Under Delaware law, a corporation may not, in general, engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction.

***We do not currently intend to pay dividends on our common stock and, consequently, your ability to achieve a return on your investment will depend on appreciation in the price of our common stock.***

We do not intend to declare and pay dividends on our common stock for the foreseeable future. We currently intend to invest our future earnings, if any, to fund our growth. Additionally, the terms of our credit facility restrict our ability to pay dividends. Therefore, you are not likely to receive any dividends on your common stock for the foreseeable future.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Unregistered Sales of Equity Securities**

None.

**Purchases of Equity Securities by QuinStreet**

In November 2011, we announced that our Board of Directors authorized a stock repurchase program allowing us to repurchase up to \$50.0 million of our outstanding shares of common stock. Repurchases under this program took place in the open market and was made under a Rule 10b5-1 plan. The amount authorized by the Company's Board of Directors excluded broker commissions.

All of our stock repurchased during fiscal year 2012 and the first quarter of fiscal year 2013 was made pursuant to this stock repurchase plan through open market purchases. We completed this repurchase program in the first quarter of fiscal year 2013, and the following table summarizes the stock repurchase activity for the first quarter of fiscal year 2013:

	Shares Repurchases			Approximate Dollar Value of Shares that May Yet Be Purchased Under the Programs (in millions)
	Total Number of Shares Purchased	Average Price Paid per Share <sup>(1)</sup>	Total Number of Shares Purchased as Part of Publicly Announce Programs	
July 1, 2012 - July 31, 2012	509,565	\$ 9.75	509,565	\$ 0.0
August 1, 2012 - August 31, 2012		\$		\$
September 1, 2012 - September 30, 2012		\$		\$

(1) Excludes \$0.02 per share broker commission.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not Applicable.

**ITEM 5. OTHER INFORMATION****Submission of Matters to a Vote of Security Holders**

None.

**Table of Contents**

**ITEM 6. EXHIBITS**

**Exhibit**

<b>Number</b>	<b>Description of Document</b>
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herewith.

Furnished herewith.

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

**Table of Contents**

**SIGNATURES**

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

QUINSTREET, INC.

/s/ Kenneth Hahn

Kenneth Hahn

Chief Financial Officer

(Principal Financial Officer and duly authorized signatory)

and Chief Operating Officer

Date: November 5, 2012

**Table of Contents**

INDEX TO EXHIBITS

<b>Exhibit</b>	
<b>Number</b>	<b>Description of Document</b>
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document
101.SCH**	XBRL Taxonomy Extension Schema Document
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herewith.

Furnished herewith.

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.