

IMPROVENET INC  
Form 10-Q  
May 15, 2001

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

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Form 10-Q

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
for the quarterly period ended March 31, 2001.

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 NUMBER 000-29927

IMPROVENET, INC.

(Exact name of registrant as specified in its charter)

Delaware

77-0452868

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification Number)

**720 Bay Road, Suite 200 Redwood City, CA 94063-2469**

(Address of principal executive offices)

**(650) 701-8000**

(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

The number of shares outstanding of the registrant's common stock, \$.001 par value, was 18,181,237 as of April 30, 2001

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ImproveNet, Inc.

Form 10-Q

For the Quarter Ended March 31, 2001

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## PART I FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### IMPROVENET, INC.

#### CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	<u>MARCH 31,</u> <u>2001</u>	<u>DECEMBER 31,</u> <u>2000</u>
	(UNAUDITED)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$22,083	\$31,565
Accounts receivable, net of allowances of \$1,632 in 2001 and \$1,525 in 2000	2,597	2,309
Prepaid expenses	1,586	2,289
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Total current assets	26,266	36,163
Property and equipment, net	3,159	4,261

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Other assets	1,373	1,292
<b>Total assets</b>	<b>\$30,798</b>	<b>\$41,716</b>
<b>Liabilities &amp; Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$2,130	\$2,796
Accrued liabilities	2,812	3,970
Accrual for restructuring	1,222	-
Deferred revenue	147	249
<b>Total current liabilities</b>	<b>6,311</b>	<b>7,015</b>
Long-term liabilities	108	99
<b>Total liabilities</b>	<b>6,419</b>	<b>7,114</b>
Stockholders' equity		
Common stock, \$0.001 par value:		
Authorized: 100,000,000 shares		
Issued and outstanding: 18,181 shares in 2001 and 18,016 shares in 2000	18	18
Additional paid-in capital	146,266	146,334
Unearned stock-based compensation	(10,363)	(11,999)
Accumulated deficit	(111,542)	(99,751)
<b>Total stockholders' equity</b>	<b>24,379</b>	<b>34,602</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$30,798</b>	<b>\$41,716</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**IMPROVENET, INC.**

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

	<b>THREE MONTHS ENDED MARCH 31,</b>	
	<b>2001</b>	<b>2000</b>
	<b>(UNAUDITED)</b>	<b>(UNAUDITED)</b>
Revenues		
Service revenues	\$1,138	\$782

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Marketing revenues	473	510
<hr/>		
Total revenues	1,611	1,292
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Cost of revenues		
Cost of service revenues (excludes stock-based compensation of \$125 in 2001 and \$244 in 2000)	1,277	1,007
Cost of marketing revenues (excludes stock-based compensation of \$51 in 2001 and \$88 in 2000)	136	47
<hr/>		
Total cost of revenues	1,413	1,054
<hr/>		
Gross profit	198	238
<hr/>		
Operating expenses:		
Sales & marketing (excludes stock-based compensation of \$1,090 in 2001 and \$1,872 in 2000)	6,381	10,464
Product development (excludes stock-based compensation of \$0 in 2001 and \$46 in 2000)	1,057	1,240
General & administrative (excludes stock-based compensation of \$143 in 2001 and \$461 in 2000)	1,566	1,584
Stock-based compensation	1,409	2,711
Restructuring charge	1,992	-
<hr/>		
Total operating expenses	12,405	15,999
<hr/>		
Operating loss	(12,207)	(15,761)
<hr/>		
Interest income	416	395
<hr/>		
Net loss	\$(11,791)	\$(15,366)
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Basic & diluted net loss per share	\$(0.67)	\$(3.42)
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Weighted average shares used in calculating basic and diluted net loss per share	17,672	4,491
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The accompanying notes are an integral part of these condensed consolidated financial statements.

## IMPROVENET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)

	THREE MONTHS ENDED MARCH 31,	
	2001	2000
	(UNAUDITED)	(UNAUDITED)
<b>Cash flows from operating activities:</b>		
Net loss	\$(11,791)	\$(15,366)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	409	230
Restructuring charges	1,992	-
Allowance for doubtful accounts	107	76
Amortization of stock based compensation	1,409	2,711
Warrant charges amortized	84	84
Notes receivable from related party	(60)	-
Net change in operating assets and liabilities:		
Accounts receivable	(395)	(837)
Prepaid expenses	703	(2,418)
Other assets	(1)	308
Accounts payable and accrued liabilities	(1,824)	1,025
Deferred revenue	(102)	59
Other long-term liabilities	-	9
Net cash used in operating activities	(9,469)	(14,119)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(38)	(1,268)
Restricted cash	(60)	-
Net cash used in investing activities	(98)	(1,268)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock, net of offering costs	-	39,075
Proceeds from exercise of stock options	76	35
Payment of long-term debt	9	-
Net cash provided by financing activities	85	39,110
Net (decrease) increase in cash and cash equivalents	(9,482)	23,723

<b>Cash and cash equivalents, beginning of period</b>	31,565	45,291
<b>Cash and cash equivalents, end of period</b>	\$22,083	\$69,014

The accompanying notes are an integral part of these condensed consolidated financial statements.

## IMPROVENET, INC.

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### 1. FORMATION AND BUSINESS OF THE COMPANY

##### *Nature of the business*

ImproveNet, Inc. ("ImproveNet" or the "Company") (formerly Netelligence, Inc.) was incorporated in California in January 1996 and reincorporated in Delaware in September 1998. The Company is a source for home improvement information and services on the Internet. Through its ImproveNet.com and ImproveNetPro.com Web sites, matching services and targeted advertising, the Company is creating a national marketplace for home improvement products and services in which homeowners, service providers and suppliers of home improvement products and related services benefit from an organized and efficient online flow of information and communication. The Company generates quality job leads for architects, designers and contractors, or service providers, from interested homeowners within their geographic area using its proprietary matching service. The Company's online features are complemented by personal assistance from a professional staff of personal project advisors and regional and area managers who offer support throughout each phase of the home improvement process.

##### *Basis of Presentation*

The accompanying interim condensed consolidated financial statements as of March 31, 2001 and for the three months ended March 31, 2001 and 2000 are unaudited. The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the annual condensed consolidated financial statements and, in the opinion of management, reflect all adjustments, which are of a normal recurring nature, necessary to present fairly the Company's financial position as of March 31, 2001, results of operations for the three months ended March 31, 2001 and 2000, and cash flows for the three months ended March 31, 2001 and 2000. The Company's results for an interim period are not necessarily indicative of the results that may be expected for the year.

Although the Company believes that all adjustments necessary for a fair presentation of the interim periods presented are included and that the disclosures are adequate, these condensed consolidated financial statements and notes thereto are unaudited and should be read in conjunction with the audited condensed consolidated financial statements and notes thereto for the year ended December 31, 2000 included in the Company's Form 10-K filed on April 10, 2001 with the Securities and Exchange Commission. The balance sheet at December 31, 2000 has been derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles in the United States of America. Such disclosures are contained in our annual report on Form 10-K.

The Company has completed several rounds of private equity financing and raised, in its initial public offering, approximately \$39.7 million, net of issuance cost, in March 2000. However, the Company has incurred substantial negative cash flows from operations in every fiscal period since inception. For the year ended December 31, 2000, the Company incurred a loss from operations of approximately \$57.8 million and negative cash flows from operations of \$49.3 million. As of March 31, 2001 the Company had an accumulated deficit of approximately \$111.5 million. Management expects operating losses and negative cash flows to continue for the foreseeable future.

The Company expects that losses will decrease from fiscal year 2000 levels due to new sales initiatives and operational cost efficiencies, through decreased marketing expenditure and reductions in headcount. Operational cost efficiency restructuring has already been initiated - the Company reduced headcount by 7% in July 2000 and further reduced headcount by 25% in March 2001. If working capital decreases significantly the Company could further reduce expenses. The Company has \$22.1 million of cash and cash equivalents at March 31, 2001. Failure to generate sufficient revenues, raise additional capital or reduce certain operational discretionary spending could have a material adverse effect on the Company's ability to continue as a going concern and to achieve its intended business objectives.

#### 2. NET LOSS PER SHARE

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Basic net loss per share is calculated by dividing net loss by the average number of outstanding shares during the period. Diluted net loss per share is calculated by adjusting the average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method. For all periods presented, potentially dilutive convertible preferred stock, stock options and warrants were excluded from the calculation of diluted net loss per share, as their effect would have been anti-dilutive.

Options to purchase approximately 0.9 million shares and warrants to purchase approximately 1.3 million shares were outstanding as of March 31, 2001.

A reconciliation of the numerator and denominator used in the calculation of the basic and diluted net loss per share follows: (in thousands, except per share amounts):

	Three Months Ended March 31	
	2001	2000
<b>Numerator</b>		
Net loss attributable to stockholders	\$(11,791)	\$(15,366)
<b>Denominator</b>		
Weighted average shares	18,181	5,038
Weighted average shares subject to repurchase	(509)	(547)
<b>Denominator for basic and diluted calculation</b>	<b>17,672</b>	<b>4,491</b>
Basic and diluted net loss per common share	\$(0.67)	\$(3.42)

### 3. Multi-Year Commercial Contracts

The Company has entered into multi-year commercial marketing contracts, some of which are with related parties. These commercial contracts generally provide marketing services that include a mix of banners and button advertising, SmartLeads and other marketing services, including FIND-A-CONTRACTOR or POWERED BY IMPROVENET, plus a continuous presence, as defined, on the Company's Web sites for a fixed annual fee. These commercial contracts are for periods ranging between 2 and 12 years, including renewal options. These commercial contracts also include cooperative marketing arrangements under which the Company is obligated to fund, as defined, co-operative marketing expenditures on television and in the print media, with or on behalf of the commercial party. Most commercial contracts provide for the Company to spend 50% to 100% of the fees the Company expects to receive. In return, the Company expects to receive significant marketing benefits including better advertising rates, stronger brand recognition, and access to customer databases, direct mail inserts and marketing resources - all designed to generate more traffic to its sites and jobs to its proprietary matching services.

As the Company does not have an established historical practice of selling advertising for cash for similar multi-year commercial contracts, the Company has not assigned any value to the exchange of services or barter element of these transactions and accordingly, the Company has not recorded either revenue or sales and marketing expense for the barter element. However, some of these multi-year commercial contracts do generate an overall net cash component to the Company, and in these cases, the Company has recorded revenue based on the cash received or receivable under the contract, net of the obligation, if any, to reimburse the commercial party for the cooperative marketing and other marketing services. These revenues are recognized over the term of the commercial contract once marketing and other services have been delivered to the commercial party and collection of the resulting net receivable is deemed probable.

Furthermore, in connection with certain of these multi-year commercial contracts, the Company also issued warrants to purchase shares of the Company's common stock to the commercial parties. These warrants have been valued by the Company using the Black Scholes option pricing model. As the fair value of these warrants represent an additional rebate on the revenue otherwise recorded under the contracts, the amortization of the warrants is further netted against this revenue over the term of the respective commercial contract. To the extent that there is insufficient revenues, the remaining amortization of warrant stock-based compensation is expensed and characterized as sales and marketing expense.

As a result, for the three months ended March 31, 2001, the Company has not recognized revenue of \$403,000 which represents \$84,000 of warrant stock-based compensation amortization and \$319,000 for the barter element amounts of these commercial contracts. For the three months ended March 31, 2000, the Company has not recognized revenue of approximately \$700,000 which represents \$84,000 of warrant stock-based compensation amortization and approximately \$616,000 for the barter element amounts of these commercial contracts.

#### 4. Segment Information

The Company currently operates in a single business segment as there is only one measurement of profitability for its operations. Through March 31, 2001, foreign operations have not been significant in either revenues or investments in long-lived assets.

A summary of the Company's revenue by service offerings is as follows (in thousands):

	Three Months Ended March 31	
	2001	2000
Service revenues:		
Lead fees	\$336	\$268
Win fees	704	347
Other fees	98	167
Total service revenues	1,138	782
Marketing revenue	473	510
Total service and marketing revenues	\$1,611	\$1,292

For the three month periods ended March 31, 2001 and 2000, no customers represented over 10% of service or marketing revenues.

#### 5. Comprehensive Loss

The Company follows SFAS No. 130, "Reporting Comprehensive Income" ("SFAS No. 130"). SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. There was no difference between the Company's net loss and its comprehensive loss for any of the periods presented in the accompanying condensed consolidated statements of operations.

#### Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." In June 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities: Deferral of the effective date of FASB Statement No. 133. An amendment of FASB Statement 133, SFAS No. 133 is effective for fiscal years beginning after June 15, 2000 and requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and the type of hedge transaction. We do not expect the adoption of FAS No. 133 to have a material impact on our financial position or results of operations.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB"). No. 101, "Revenue Recognition in Financial Statements." SAB 101 discusses certain generally accepted accounting principles regarding revenue recognition in financial statements, including the specification of certain criteria that should be met before revenue is recognized. These criteria include: persuasive evidence that an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured. In March 2000, the SEC issued SAB No. 101A, "Amendment: Revenue Recognition in Financial Statements," and SAB No. 101B, "Second Amendment: Revenue Recognition in Financial Statements," to defer for the effective date of implementation of SAB No. 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999, with earlier application encouraged. We adopted SAB No. 101, as amended, in the quarter ended December 31, 2000. The adoption of SAB No. 101, as amended, has not had a material effect on our financial position or results of operations.

#### 6. RELATED PARTY TRANSACTIONS

##### *Notes Receivable from Officer*

In May 1999, the Company entered into an employment related promissory note agreement with its Chairman and Chief Executive Officer, Ronald B. Cooper, whereby the Company agreed to loan the officer up to \$500,000. The full amount was loaned in August 1999. The note accrues interest at 5.25% per annum and is due and payable on the earlier of April 1, 2002 or within 90 days after the voluntary termination of the officer's employment or the termination of the officer's employment for cause. The note is collateralized by the officer's shares of stock



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and options to purchase shares of stock. In April 2000, the Company loaned its Chairman and Chief Executive Officer \$1.0 million accruing interest at a rate of 6.46% per annum and repayable on the earlier of April 30, 2002 or when the borrower is able to collateralize or borrow on margin using his Company stock. Both loans are collateralized by the stock owned by the borrower. In accordance with FAS 114 "Accounting by Creditors for Impairment of a Loan", these notes receivable are valued at the market value of the stock held as collateral. At March 31, 2001, the value of the stock held increased by \$60,000.

### 7. RESTRUCTURING ACCRUAL

The restructuring charges were determined based on formal plans approved by the Company's management using the best information available to it at the time. The amounts the Company may ultimately incur may change as the restructuring initiative is executed.

The activity impacting the accrual for restructuring charges during 2001 are summarized in the table below:

(in thousands)	Balance at December 31, 2000	Charges to Operations in three months ended March 31, 2001	Charges Utilized in three months ended March 31, 2001	Balance at March, 31, 2001
Facilities	\$-	\$593	\$-	\$593
Workforce reductions	-	629	-	629
Asset write-downs	-	770	-	770
<b>Total</b>	<b>-</b>	<b>\$1,992</b>	<b>-</b>	<b>\$1,992</b>

60 employees were terminated as part of the restructure as of April 1, 2001. These employees were primarily sales and administrative staff. No termination benefits have been charged against the liability as the termination occurred post quarter end.

The March 31, 2001 accrual for restructuring and merger-related charges is classified within the balance sheet as follows:

	(in thousands)
Accrual for restructuring charges	\$1,222
Property, plant and equipment, net	770
	<b>\$1,992</b>

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read with our condensed consolidated financial statements and notes included elsewhere in this Report on Form 10-Q. The discussion in this Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. The cautionary statements made in this Report on Form 10-Q should be read as applying to all related forward-looking statements wherever they appear in this Report on Form 10-Q. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to these differences include those discussed in "Business Risks" below as well as those discussed elsewhere.

### OVERVIEW

Our business started in January 1996 as a regional contractor matching service, and we spent most of 1996 and 1997 building our service provider database, developing new services and technology, recruiting personnel and raising capital. We launched our Web site and homeowner/service provider matching service on a national scale in August 1997. In December 1998, we began selling Web site advertising, including SmartLeads services, a way for suppliers of home improvement products to send targeted messages about their products, including product promotions, to homeowners at the time of purchase, as well as to our network of service providers. In March 1999, we began to hire our new senior management team, including our chief executive officer. In April 1999, we introduced Powered by ImproveNet, a service that allows third parties to offer the ImproveNet matching services and content on their Web sites, for national suppliers of home improvement and repair products. We completed the acquisition of two regional contractor referral companies, Contractor Referral Service, LLC and The J.L. Price Corporation, in September and November 1999, these entities were integrated into our operations during the course of calendar year 2000. In November 1999, we launched our customized Web site, www. ImproveNetPro.com, for our network of service providers. In March 2000, we

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completed our IPO. From January through June 2000 we spent substantial amounts primarily on marketing and other marketing related activities, as well as the development and expansion of our service and operations infrastructure. In July 2000 we had a reduction in force, reducing our staff by approximately 7%. Additionally, in March 2001 we restructured our operations, resulting in a staff reduction of 25% and we intend closing our main facility in Redwood City, California. During the final two quarters of the year 2000 our operating expenses (including cost of revenues) decreased by 22% in the third quarter and another 16% in the fourth quarter, but excluding the non-cash write-down of notes receivable. We expect operating expenses to decline for the entire calendar year 2001 as compared to calendar year 2000.

We generate substantially all of our revenues from service provider referral services, marketing partnership packages and advertisements placed on our Web site. We generate service revenues primarily in the form of lead fees and win fees from our service providers and, to a much lesser extent, other fees for the enrollment of service providers and premium service fees from homeowners. We generate marketing revenues from the sale of banner, button and other advertising on our Web sites, and from the sale to suppliers of SmartLeads generated from the traffic of homeowners visiting our Web sites and from the sale of Find-A-Contractor or Powered by ImproveNet products in commercial agreements. Our marketing revenues generally come from suppliers of home improvement products.

Commencing in September 1999, we entered into multi-year commercial contracts, some of which are with related parties. These commercial contracts generally provide for a fixed annual fee, an advertising or branding package that includes a mix of buttons, banners, SmartLeads and other marketing or branding services, including Find-A-Contractor or Powered by ImproveNet, plus a continuous presence on our Web sites.

### RESULTS OF OPERATIONS

#### REVENUES

Our revenues increased to \$1.6 million for the three months ended March 31, 2001 from \$1.3 million for the three months ended March 31, 2000, an increase of \$319,000 or 25%.

The increase in revenues was attributable to increased service revenues achieved by increased visitors to the ImproveNet site, an increase in the number of job submissions, improved match rate and the continued building of a network of service providers. The increase was partially offset by a decrease in marketing revenues.

The following table and discussion highlights our revenues for the three months ended March 31, 2001 and 2000 (in thousands):

	Three Months Ended March 31,		
	2001	2000	% Change
<b>Revenues:</b>			
Service Revenue	\$1,138	\$782	46%
Marketing Revenue	473	510	(7%)
<b>Total Revenue</b>	<b>\$1,611</b>	<b>\$1,292</b>	<b>25%</b>

#### *Service Revenues*

Service revenues increased to \$1.1 million for the three months ended March 31, 2001 from \$782,000 for the three months ended March 31, 2000, an increase of \$356,000 or 46%.

In calendar year 2000, and for calendar year 2001 through March 21, 2001, the win fees that we charged to our service providers depend on project size and range from 2% to 10% of the estimated cost of the job, up to a maximum of \$995 per job. Effective March 22, 2001, the win fees we charge our service providers depend on project size and range from 1% to 10% of the estimated cost of the job, without a maximum per job. Effective March 22, 2001, we also reduced lead fees by 20%. The lead fee had been standardized at \$10 a lead for all jobs in November 1999. Other fees include an enrollment fee of \$90 that we charge each new service provider who passes our quality screens to join our national

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network. In calendar year 2000 and prior, we often discounted or waived the enrollment fee.

Lead fee revenues are recognized at the time the service providers and the homeowner are first matched, while win fee revenues are recognized at the time the service provider or the homeowner notifies us that a job has been sold. For both lead fees and win fees, the recognition of revenues coincides with the service providers' obligation to pay us. The following table details the components of service revenues, based on a percentage of service revenues:

	Three Months Ended March 31,	
	2001	2000
	%	%
Lead Fees	30	34
Win Fees	62	44
Other Fees	8	22
Total Service Revenue	100	100

The revenues we generate from lead and win fees are largely a function of:

- the number of job submissions;
- the effectiveness in finding a service provider or match for each job submission;
- the success of the service provider to win a job; and
- the amount we charge the service provider for a lead or a win.

The following table provides information on some of our key business metrics (numbers in thousands):

Key Metrics	Three Months Ended March 31,	
	2001	2000
Job submissions	35.4	29.5
Matched jobs	23.8	18.1
Won jobs	2.5	1.8
Matched jobs as a % of job submissions	67.2%	61.4%
Won jobs as a % of job submissions	7.1%	6.1%

Revenues from new service provider enrollment fees are recognized as revenue ratably over the expected period they participate in our contractor matching service, which is initially estimated to be one year. Revenues from premium service fees to homeowners are recognized at the time the service is provided.

### **Marketing Revenues**

Marketing revenues decreased to \$473,000 for the three months ended March 31, 2001 from \$510,000 for the three months ended March 31, 2000, a decrease of \$37,000 or 8%.

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We generate marketing revenues from the sale of banner, button and other advertising on our Web sites, and from the sale to suppliers of SmartLeads generated from the traffic of homeowners visiting our Web sites and from the sale of Find-A-Contractor or Powered by ImproveNet products in commercial agreement products and services. Our marketing revenues generally come from suppliers of home improvement products.

Revenues from banner, button and other branding are largely a function of:

the number of Web pages that we serve;  
the percentage of those pages on which we are able to sell advertisements; and  
the amount we charge per advertisement.

Advertisers pay us to display their banner, button and other advertisements on the Web pages we serve when a user is visiting our Web sites. Our marketing revenues historically have been derived from short-term advertising contracts based on either a guaranteed minimum number of impressions or a fixed fee per thousand impressions. We anticipate that these advertising revenues will remain flat or decline during 2001 as advertisers demand better monetary terms for the same number of impressions or more impressions for the same dollar amounts.

### ***Cash Advertising***

Cash advertising revenues generally are derived from short-term advertising contracts in which we typically guarantee that a minimum number of impressions will be delivered to our Web site visitors over a specified period of time for a fixed fee. Cash advertising revenues from banner, button and other Web site advertisements are recognized at the lesser of the amount recorded ratably over the period in which the advertising is delivered or the percentage of guaranteed impressions delivered.

SmartLeads are also paid for in cash and revenues are recognized when the SmartLeads have been delivered to the customer. Cash advertising is recognized when we have delivered the advertising, evidence of an agreement is in place and fees are fixed, determinable and collectible. Cash advertising decreased to \$48,000 for the three months ended March 31, 2001 from \$205,000 for the three months ended March 31, 2000, a decrease of \$157,000 or 77%. This decline is reflective of the slowdown in internet advertising spending.

### ***Barter Advertising***

Barter advertising comes from multi-year commercial contracts. Barter advertising is recognized in accordance with EITF No. 99-17, "Accounting for Advertising Barter Transactions", which we adopted in 1999. Under EITF No. 99-17, we record advertising transactions at fair value only when we have an established historical practice of selling similar advertising for cash. The characteristics of the advertising that must be similar include the duration of the display of the advertising, the prominence and positioning of the advertising, the intended audience, the timing of the advertising and its circulation.

For the three months ended March 31, 2001, we did not recognize revenue of \$403,000 which represents \$84,000 of warrant stock-based compensation amortization, and \$319,000 for the barter element amounts of these commercial contracts. For the three months ended March 31, 2000, the Company did not recognize revenue of approximately \$700,000 which represents \$84,000 of warrant stock-based compensation amortization, and \$616,000 for the barter element amounts of these commercial contracts.

### ***Multi-year Commercial Contracts***

Commencing September 1999, we entered into multi-year commercial contracts, some of which are with related parties. These commercial contracts generally provide for a fixed annual fee, an advertising or branding package that includes a mix of buttons, banners, SmartLeads and other marketing or branding services, including Find-A-Contractor or Powered by ImproveNet, plus a continuous presence, on our Web sites. These commercial contracts are for periods ranging between 2 and 12 years, including renewal options. These commercial contracts also include cooperative marketing arrangements under which we are obligated to fund co-operative branding expenditures on television and in the print media, with or on behalf of the commercial party. Most commercial contracts provide for us to spend 50% to 100% of the fees that we expect to receive. In return, we expect to receive significant marketing and branding benefits including better advertising rates, stronger brand recognition, and access to customer databases, direct mail inserts and marketing resources - all designed to generate more traffic to sites and jobs to proprietary matching services.

We do not have an established historical practice of selling advertising for cash for similar multi-year commercial contracts, we have not assigned any value to the exchange of services or barter element of these transactions and accordingly, we have not recorded either revenue or sales and branding expense for the barter element. However, some of these multi-year commercial contracts do generate an overall net cash component, and in these cases we have recorded revenue based on the cash received or receivable under the contract, net of the obligation, if any, to reimburse the commercial party for the cooperative branding and other marketing services. These revenues are recognized over the term of the commercial contract once advertising and other services have been delivered to the commercial party and collection of the resulting net

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receivable is deemed probable. Revenue from multi-year commercial contracts, net of warrant charges, totaled \$425,000 for the three months ended March 31, 2001, and \$305,000 for the three months ended March 31, 2000.

Furthermore, in connection with certain of these multi-year commercial contracts, we issued warrants to purchase shares of our common stock to the commercial parties. These warrants have been valued by us using the Black Scholes option pricing model. As the fair value of these warrants represent an additional rebate on the revenue otherwise recorded under the contracts, the amortization of the warrants is further netted against this revenue over the term of the respective commercial contract. To the extent that there is insufficient revenues, the remaining amortization of warrant stock-based compensation is expensed and characterized as sales and branding expense.

Total revenues may be analyzed as follows (in thousands):

	Three Months Ended March 31,	
	2001	2000
Service revenues	\$1,138	\$782
Marketing revenues	876	1,210
Less: Amounts invoiced and accrued under multi-year commercial contracts with related parties	(319)	(616)
Less: Amortization of warrant stock-based compensation	(84)	(84)
Total marketing revenues	473	510
Total revenues	\$1,611	\$1,292

### OPERATING EXPENSES

#### *Cost of Revenues*

Our cost of revenues increased to \$1.4 million for the three months ended March 31, 2001 from \$1.1 million for the three months ended March 31, 2000, an increase of \$359,000 or 34%.

Cost of revenues consists of payroll and related costs and occupancy, telecommunications and other administrative costs for our project services group, which is responsible for all phases of our proprietary matching services and includes our project advisors. In addition, cost of revenues includes an allocation of direct Web site operations costs, consisting of payroll and related costs, data transmission costs and equipment depreciation. We anticipate that our cost of revenues will remain constant or decline during the remainder of 2001, as compared to year 2000 as we plan to leverage our existing infrastructure.

#### *Cost of Service Revenues*

Our cost of service revenues increased to \$1.3 million for the three months ended March 31, 2001 from \$1.0 million for the three months ended March 31, 2000, an increase of \$270,000 or 27%.

The increase in cost of service revenues is largely attributable to our investment in the expansion and staffing of our project services infrastructure to support volume increases in traffic and jobs to our site. In addition, the increase in cost of service revenues was a result of facilities and office expenses related to the full build-out, started in the first quarter of 2000 and completed in July 2000, of our second support center located in Camarillo, California.

#### *Cost of Marketing Revenues*

Our cost of marketing revenues increased to \$136,000 for the three months ended March 31, 2001 from \$47,000 for the three months ended March 31, 2000, an increase of \$89,000 or 189%.

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Cost of marketing revenue includes an allocation of direct Web site operations costs, consisting of payroll and related costs, data transmission costs and equipment depreciation. The increase in cost of marketing revenue was primarily attributable to the growth in staffing, services and equipment required to maintain the Web site operations.

### ***Sales and Marketing***

Our sales and marketing expense decreased to \$6.4 million for the three months ended March 31, 2001 from \$10.5 million for the three months ended March 31, 2000, a decrease of \$4.1 million or 39%.

Our sales and marketing expense includes all of our online and offline direct marketing and advertising, public relations and trade show expenses. Sales and marketing expenses also include payroll and related costs, support staff expenses, travel costs and other general expenses of our marketing, professional services and partnership services departments.

The decrease in sales and marketing expenses was primarily attributable to a decline in online and offline brand advertising.

At the end of June 2000, we redirected our sales and marketing resources by executing more projects internally and negotiating or transitioning new or existing agreements from a high fixed cost formula to a variable performance-based formula keyed to won jobs. We significantly decreased sales and marketing expenses in the fourth quarter of 2000 and fully anticipate that these expenses will decline during 2001, as compared to year 2000 as we plan to leverage our existing infrastructure and to continue the process of negotiating or transitioning agreements from a high fixed cost formula to a variable performance-based formula keyed to won jobs.

### ***Product Development***

Our product development expenses decreased to \$1.1 million for the three months ended March 31, 2001 from \$1.2 million for the three months ended March 31, 2000, a decrease of \$83,000 or 15%.

Our product development costs include the payroll and related costs of our editorial and technology staff, fees for contract content providers, other costs of Web site design and new technologies required to enhance the performance of our Web sites.

The decrease in product development expenses were primarily attributable to decreased payroll and related costs and decreased usage of contract content providers. A major portion of product development costs for the first half of 2000 was attributable to a major new product and service that has been terminated. We expect a decline in our product development expenses during 2001, as compared to year 2000 due to the termination of the previously mentioned new product and service initiative and that we have completed most of our major development efforts.

### ***General and Administrative***

Our general and administrative expenses were nearly identical at \$1.6 million for the three months ended March 31, 2000 and 2001.

Our general and administrative expenses include payroll and related costs and travel, recruiting, professional and advisory services and other general expenses for our executive, finance and human resource departments.

### ***Stock-based Compensation***

Our stock-based compensation expenses decreased to \$1.4 million for the three months ended March 31, 2001 from \$2.7 million for the three months ended March 31, 2000, a decrease of \$1.3 million or 48%.

In connection with certain employee and non-employee stock option grants during 1998 and 1999, we recorded unearned stock-based compensation totaling \$13.8 million, which is being amortized over the vesting periods of the related options, generally four years using the method set out in FASB Interpretation No. 28 ("FIN 28"). Under the FIN 28 method, each vested tranche of options is accounted for as a separate option grant awarded for past services. Accordingly, the compensation expense is recognized over the period during which the services have been provided. This method results in higher compensation expense in the earlier vesting periods of the related options. Stock based compensation charges associated with employees who terminate their employment with us and have unvested options are reversed.

### ***Interest Income***

Our interest income increased to \$416,000 for the three months ended March 31, 2001 from \$395,000 for the three months ended March 31, 2000, an increase of \$21,000 or 5%.

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The increase in interest income is attributable to an increase in our average invested cash balances. We expect a decline in our interest income during the remainder of 2001 due to the expected decline in our cash and cash equivalents balances during the year 2001.

### ***Income Taxes***

We have recorded a 100% valuation allowance against our net deferred tax assets, which arose primarily as a result of our aggregate operating losses. The valuation allowance will remain at this level until such time as we believe that the realization of the net deferred tax assets is more likely than not. Accordingly, our results of operations do not reflect any tax benefits for our reported losses.

### ***LIQUIDITY AND CAPITAL RESOURCES***

Cash and cash equivalents totaled \$22.1 million at March 31, 2001 a decrease of \$9.5 million or 30% from \$31.6 million at December 31, 2000. Most of the decrease primarily came from the \$9.5 million cash used in operating activities which largely reflected our net loss for the period.

Since our inception, we have primarily financed our operations through private sales of our convertible preferred stock and common stock. In March 2000, we closed our initial public offering that generated net cash proceeds of approximately \$39.7 million. Our primary capital needs have been to fund our operating losses; the prepayment of our large media purchases and to make capital expenditures.

Net cash used in operating activities was \$9.5 million in the three months ended March 31, 2001, a decrease of \$4.6 million from \$14.2 million for the three months ended March 31, 2000, primarily due to decrease in our net loss as a result of our restructuring late 2000 and 2001, where operating expenditures reduced significantly.

Net cash used in investing activities was \$98,000, a decrease of \$1.2 million from \$1.3 million in the periods ended March 31, 2001 and 2000 due to the focus of the business in restructuring operations in 2001, and necessary decreases in capital expenditures. Net cash used in investing activities was a result of purchase of property and equipment related to upgrading the leased facilities at our Oddstad Road facility in Redwood City, which will be our headquarters location during the second quarter of 2001.

Net cash provided by financing activities has decreased by \$39 million from \$39 million to \$82,000 in the periods ended March 31, 2000 and 2001 due to the issuance of common stock in the period ended March 31, 2000.

Our capital requirements depend on numerous factors, including the success of our strategies for generating revenues and the amount of resources we devote to operating activities, including sales, marketing and brand promotion and investments in our technology. Our expenditures have substantially increased since inception as our operations and staff have grown. Based on the realignment of our resources, we expect a decrease in most of our operating expenses categories detailed above for the year 2001 as compared to year 2000. Additionally, we expect our capital expenditures for 2001 to decrease significantly. We do expect to experience ongoing operating losses for the foreseeable future. We currently anticipate that our operating expenses, primarily sales and marketing expenditures, and payroll and related costs will constitute a significant use of our current cash resources.

Our limited operating history and operating losses have limited our ability to obtain vendor credit or extended payment terms and bank financing on favorable terms; accordingly, we depend on our cash and cash equivalent balances to fund our operations.

We currently believe that our available cash resources will be sufficient to meet our anticipated needs for operations and capital expenditures. We will strive to make ongoing realignments, as required, to achieve positive cash flow with our existing cash resources. We restructured our operations and we have reduced our headcount during the year ended December 31, 2000 and also in the quarter ended March 31, 2001, as well as subsequent to the quarter end. We are additionally decreasing our marketing expenditures to assist us in maintaining our available cash resources. We may need to raise additional funds, however, in order to fund more rapid expansion, to develop new or enhance existing services, to respond to competitive pressures or to acquire complementary businesses, services or technologies. If we raise additional funds by selling equity securities, the percentage ownership of our stockholders will be reduced. We cannot be sure that additional financing will be available on terms favorable to us, or at all. If adequate funds are not available on acceptable terms, our ability to fund expansion, react to competitive pressures, or take advantage of unanticipated opportunities would be substantially limited. If this occurred, our business would be significantly harmed. We will continue to evaluate our needs for funds based on our assessment of access to public or private capital markets and the timing of our need for funds. Although we have no present intention to conduct additional public equity offerings, we may seek to raise these additional funds through private or public debt or equity financings.

### **RISK FACTORS THAT MAY AFFECT OUR RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

This document contains certain forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "anticipates", "believes", "continue", "could", "estimates",

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"expects", "intends", "plans", "potential", "predicts", "should" or "will" or the negative of these terms or other comparable terminology which are intended to identify certain of these forward-looking statements. The cautionary statements made in this document should be read as being applicable to all related forward-looking statements wherever they appear in this document. The Company's actual results could differ materially from those discussed in this document. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed in the Company's Annual Report on Form 10-K.

### **We have large accumulated losses, we expect future losses, and we may not achieve or maintain profitability.**

We have incurred substantial losses and used substantial cash to support our operations as we have expanded our sales and marketing programs, funded the development of our services, promoted our Web sites and matching service and expanded our operations infrastructure. As of March 31, 2001, our accumulated loss was approximately \$111.5 million. We expect our expenditures on sales and marketing activities, support field services and the development of new products, services and technologies to continue at a reduced rate, as we restructured our business in March 2001. This restructuring included headcount reductions of approximately 25%. We will continue to lose money unless we significantly increase our revenues. We cannot predict when, if ever, we will operate profitably.

### **We are an early stage company and we have recently restructured our business to offer new services. As a result, we have a limited history, which makes it difficult to evaluate our business.**

We were incorporated in January 1996; however, we did not begin offering home improvement services on the Internet until August 1997. In December 1998, we began selling Web site advertising. Until March 1999, we focused primarily on building our network of service providers and refining our matching services processes. In March 1999, we hired our Chief Executive Officer and commenced recruiting our senior management. In April 1999, we introduced Powered by ImproveNet, a service that allows third parties to offer the ImproveNet matching services and content on their Web sites, for national suppliers of home improvement and repair products. In November 1999, we launched our customized Web site for service providers. We completed the acquisition of two regional contractor referral companies, Contractor Referral Service, LLC and The J.L. Price Corporation, in September and November 1999. We experienced reductions in force in July 2000. In the second half of 2000 we significantly reduced our marketing expenditures. In March 2001, we announced the restructuring. On April 1, 2001, we had a reduction in force of approximately 60 people. As a result, we have a limited history upon which you can evaluate our business and the performance of our senior management team. Furthermore, even if our business is successful, we may change our business to enter into new business areas, including areas in which we do not have extensive experience.

### **If we are unable to maintain our Nasdaq National Market listing, the liquidity of our common stock would be seriously limited.**

On January 4, 2001, we received a Nasdaq Staff Determination indicating that we have failed to comply with the minimum bid price requirement for continued listing, and are subject to delisting from the Nasdaq National Market. We are scheduled for a hearing before the Nasdaq Qualifications Panel on May 24, 2001, to review the staff determination. We can not assure you that Nasdaq Qualification Panel will decide to allow us to remain listed or that our actions will prevent the delisting of our common stock. We will not be notified until the Nasdaq Qualification Panel makes a formal decision. Until then, our shares will continue to trade on the Nasdaq National Market. In the event our shares are delisted from the Nasdaq National Market, we will attempt to have our common stock traded on the NASD over-the-counter Bulletin Board. If our common stock is delisted, it would seriously limit the liquidity of our common stock and limit our potential to raise future capital through the sale of our common stock, which could seriously harm our business.

### **Our financial results will be affected by seasonality and cyclical fluctuations in the home improvement industry.**

Our limited operating history and rapid growth make it difficult to assess the impact of seasonal factors on our business. However, our business is dependent upon the home improvement industry. As a result, we expect that our revenues may be lower during the first and fourth quarters since more homeowners commit to home improvement projects during the spring and summer months. Being dependent on the home improvement industry exposes us to cyclical movements in the economy in general, especially as they relate to consumers willingness to make large expenditures that are mostly discretionary. Our limited operating history and the state of the economy for most of our existence make it difficult to assess the impact of cyclical factors on our business.

### **Failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products and services could reduce our ability to compete and result in lower revenues.**

If we are unable to generate sufficient cash flows from operations to meet our anticipated needs for working capital and capital expenditures, we will need to raise additional funds to fund brand promotions, develop new or enhanced services or respond to competitive pressures. We cannot be certain that we will be able to obtain additional financing on favorable terms, or at all. If we need additional capital and cannot raise it on acceptable terms, we may not be able, among other things, to:

develop or enhance our services;



develop or acquire new technologies, products or businesses;

expand operations in the United States or internationally;

hire, train and retain employees; or

respond to competitive pressures or unanticipated capital requirements.

Our failure to do any of these things could result in lower revenues and could harm our business or cause us to discontinue operations.

In addition, we may seek to raise additional funds, finance acquisitions or develop commercial relationships by issuing equity or convertible debt securities, which would reduce the percentage ownership of existing stockholders. Furthermore, any new securities could have rights, preferences or privileges senior to those of our common stock.

**Our market is competitive and we may suffer price reductions, be unable to attract homeowners to our Web site, be unable to maintain our service provider network or enter into new multi-year commercial contracts if we do not compete effectively.**

The market for our services is intensely competitive, evolving and subject to rapid technological change. To remain competitive, we must continue to enhance and improve the ease of use, responsiveness, functionality and features of our online and offline services in order to attract homeowners to our Web site and maintain our service provider network. We expect the intensity of competition to increase in the future. Increased competition may result in changes in our pricing model, fewer homeowners visiting our Web site, service providers leaving our network, less marketing revenue, reduced gross margins and loss of market share, any one of which could significantly reduce our future profitability. In addition, technological barriers to entry are relatively low. As a result, current competitors, including local referral businesses and online referral companies including ServiceMagic.com, iMandi, repairnet, OurHouse.com, Handyman Online, Bid Express, Contractor.com and Remodel.com, a part of the Homestore.com family of sites and potential competitors such as The Home Depot, Lowe's and Sears Roebuck & Company have launched Web sites similar to ours that could gain broader market acceptance based on content, products and services.

Some of our competitors have more resources and broader and deeper customer access than we do. In addition, many of these competitors have or can readily obtain extensive knowledge of the home improvement industry. Our competitors may be able to respond more quickly than we can to new technologies or changes in Internet user preferences and devote greater resources than we can to the development, promotion and sale of their services. We may not be able to maintain our competitive position against current and future competitors, especially those with significantly greater resources and brand recognition.

**Homeowners and service providers may be reluctant to accept an Internet-based service provider matching service.**

Currently most homeowners use traditional means including word-of-mouth referrals, Yellow Pages and local contractor matching services to obtain service providers for their home improvement projects. In addition, many service providers do not use the Internet for business purposes and may be reluctant to become part of a network of service providers on an Internet-based service provider matching service. If homeowners do not use our matching service or service providers do not join our network, we will not be able to generate significant revenues from either services or branding, or be able to enter into new multi-year commercial contracts.

**If we do not attract and retain a network of high quality service providers, our business could be harmed.**

We expect to derive the majority of our revenues from our network of service providers in the form of payments for each homeowner referral that we provide to them and for each home improvement project that they win. Our business is highly dependent on homeowners' use of our Web site to find service providers for their home improvement projects so that service providers will achieve a satisfactory return on their participation in the ImproveNet program.

A key element of the growth of our business is the pace at which service providers adopt the ImproveNet matching process. This adoption includes responding to homeowner inquiries within 72 hours, providing a competitive, firm quote to homeowners quickly, and paying the service fees to ImproveNet. We devote significant effort and resources to screening and supporting participating service providers and to developing programs that monitor service providers' job wins and that collect service fees from service providers for these wins. Our inability to screen and support service providers effectively, or the failure of our service providers to respond professionally and in a timely manner to homeowner inquiries, could result in low homeowner satisfaction and harm our business. In addition, the failure of our service providers to win home improvement projects, report their wins to us, or pay us service fees could harm our business.

We must actively recruit new service providers and retain and motivate our current service providers to ensure that we continually have adequate coverage. We believe that service providers in the home improvement industry suffer from a relatively high failure or turnover rate which makes it difficult for us to retain service providers. Accordingly, we expect that not all of our service providers will remain active

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participants in our network. If we are unable to achieve low turnover among our network of service providers our business could be harmed.

### **If homeowners fail to report, and service providers fail to report and to pay to us win fees, directly or indirectly, our business would be harmed.**

Our service providers are responsible for paying us a win fee for each job that they obtain from us. We ask service providers not to pass on the cost of the win fee to the homeowner. However, we do not currently provide any guarantee to the homeowner that our service providers have not raised their rates to cover the win fee nor do we audit or plan to audit our service providers to confirm that they have not raised their rates. Homeowners may believe that they are indirectly paying us our win fee through the higher rates of service providers and, therefore, choose to select service providers through word-of-mouth referrals, Yellow Pages, local contractor matching services or other means rather than using our matching service. If homeowners choose not to use our service, we will lose service revenues and visitors to our Web sites and our business will be harmed.

We depend on our service providers to report that they have won a job and pay us our win fee. We rely on personal relationships with our service providers and the incentive to receive future leads from us to encourage service providers to report wins and pay win fees. Currently, we do not have a control or an oversight mechanism in place with either service providers or homeowners to ensure that they report wins and pay win fees. If service providers do not report wins or pay us win fees, we will lose service revenues and our business will be harmed.

### **We depend on third-party relationships to attract visitors to our Web sites.**

We have entered into multi-year commercial contracts with suppliers of home improvement products and services to generate revenues and increase the number of visitors to our Web sites. Under these contracts, suppliers have placed links to our Web site from their Web sites to allow their customers to visit our Web site if the customers are interested in obtaining home improvement information or searching for a service provider. We believe that increasing the number of visitors to our Web sites will increase the number of job submissions. We cannot assure you that these contracts will lead to increased visits to our Web sites or that increased visits to our Web sites will result in increased job submissions. If we do not maintain our existing multi-year commercial contracts on terms as favorable as currently in effect or if we are not able to establish new contracts on commercially reasonable terms, our business could be harmed.

Companies that we may pursue for a multi-year commercial contract may offer services competitive with suppliers with which we currently have multi-year contracts. As a result, these suppliers may be reluctant to enter into multi-year commercial contracts with us.

We purchase preferential advertising placement on high-traffic Web sites. We believe these Web sites can help us to increase the number of visitors to ImproveNet.com. For example, in 1999 and 2000, approximately 20% and 11%, of our Web site traffic originated from AltaVista, America Online, Excite@Home, Lycos, Microsoft HomeAdvisor and Yahoo! There is intense competition for preferential placements on these Web sites. If we lose our relationships with any one of these Web sites, the traffic on ImproveNet.com may decrease and we may not be able to enter into commercially reasonable contracts with replacement high-traffic Web sites, if at all.

### **We depend on third-party relationships to provide software tools and infrastructure.**

We integrate third-party software into our service offerings on our Web sites. We would be harmed if the providers from which we license software ceased to deliver and support reliable products, to enhance their current products, or to respond to emerging industry standards. In addition, third-party software may not continue to be available to us on commercially reasonable terms or at all. The loss of, or inability to maintain or obtain, this software could limit the features available on our Web sites, which could harm our business.

### **If we fail to attract and retain qualified personnel, our ability to compete could be harmed.**

We depend on the continued service of our key technical, sales and senior management personnel. In particular, the loss of the services of Ronald B. Cooper, our President and Chief Executive Officer, or other senior management personnel, individually or as a group, could cause us to incur increased operating expenses and divert other senior management time in searching for their replacements. We do not have employment agreements with any employee, except Mr. Cooper, and we do not maintain any key person life insurance policies for any of our key employees, except for Mr. Cooper. The loss of any of our key technical, sales or senior management personnel could harm our business.

In addition, we must attract, retain and motivate highly skilled employees. We face significant competition for individuals with the skills required to develop, market and support our services. We may not be able to recruit and retain sufficient numbers of highly skilled employees, and as a result our business could suffer.

### **If we fail to adequately protect our proprietary rights, we could lose these rights and our business could be harmed.**

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We depend upon our ability to develop and protect our intellectual property rights, including our databases of homeowners and service providers and our internally-developed matching criteria and algorithms, to distinguish our services from our competitors' services. We rely on a combination of copyright, trademark and trade secret laws, as well as confidentiality agreements and licensing arrangements, to establish and protect our proprietary rights. We have no issued patents. Our databases are protected by trade secret laws and our matching service is protected primarily by trade secret and copyright laws. Existing laws afford only limited protection of intellectual property rights. Attempts could be made to copy or reverse engineer aspects of our processes or services or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to protect our intellectual property rights against unauthorized third-party copying or use. Furthermore, policing the unauthorized use of our intellectual property is difficult, and expensive litigation may be necessary in the future to enforce our intellectual property rights. The use by others of our proprietary rights could harm our business.

### **Our services could infringe the intellectual property rights of others causing costly litigation and the loss of significant rights.**

Third parties could claim that we have infringed their intellectual property rights by claiming that our matching service infringes their patents, trade secrets or copyrights. In the ordinary course of business, we have received, and may receive in the future, notices from third parties claiming infringement of their proprietary rights. In addition, providers of goods and services over the Internet are increasingly subject to claims that they infringe patents that cover basic elements of electronic commerce. The resolution of any claims could be time-consuming, result in costly litigation, delay or prevent us from offering our services or require us to enter into royalty or licensing agreements, any of which could harm our business. In the event an infringement claim against us is successful and we cannot obtain a license on acceptable terms, license a substitute technology or redesign our services, our business would be harmed. Furthermore, former employers or our current and future employees may assert that our employees have improperly disclosed to us or are using confidential or proprietary information in our business.

### **If we experience system failures, our reputation would be harmed and users might seek alternative service providers, causing us to lose revenues.**

We depend on the efficient and uninterrupted operation of our computer and communications hardware and software systems. Substantially all of our computer hardware for operating our Web sites is currently located at Qwest Communications in Sunnyvale, California, with backups located at our facility in Redwood City, California. These systems and operations are vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures and similar events. They are also subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct. We do not have fully redundant systems, a formal disaster recovery plan or alternative providers of hosting services, and we do not carry business interruption insurance to compensate us for losses that could occur. Despite any precautions we may take, the occurrence of a natural disaster or other unanticipated problems either at Qwest or at our facility could result in interruptions in our services. Any damage to or failure of our systems could result in interruptions in our service. In addition to placing an increased burden on our engineering staff, any system failure could create user questions and complaints that must be responded to by our customer support personnel. The system failures of various third-party Internet service providers, online service providers and other Web site operators could result in interruptions in our service to those users who require the services of these third-party providers and operators to access our Web sites. These interruptions could reduce our revenues and profits, and our future revenues and profits will be harmed if our users believe that our system is unreliable. Since we have been keeping logs of our Web sites, our ImproveNet.com Web site has been unintentionally interrupted for periods ranging from two minutes to one hour, the latter prior to February 2000. On one occasion, prior to February 2000, some users experienced interruptions in part of our service for a period of 48 hours.

### **We rely on a continuous power supply to conduct our business, and California's current energy crisis could disrupt our operations and increase our expenses.**

California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of acute power shortages, which occur when power reserves for the State of California fall below 1.5%, California has on occasion implemented, and is likely in the future to continue to implement, rolling blackouts throughout the state. If blackouts interrupt the power supply of our hosting provider, we would be subject to reduced access to our Web sites. Additionally, we currently do not have backup generators or alternate sources of power in the event of a blackout, and our current insurance does not provide coverage for any damages we or our customers may suffer as a result of any interruption in our power supply or that of our hosting provider. If blackouts interrupt our power supply, we would be temporarily unable to continue operations at our facilities. This could damage our reputation, harm our ability to retain existing customers and to obtain new customers, and could result in lost revenue, any of which could substantially harm our business and results of operations.

### **We may have capacity restraints that could limit the growth of or reduce our revenues.**

The satisfactory performance, reliability and availability of our Web sites, processing systems and network infrastructure are critical to our reputation and our ability to attract and retain large numbers of users. If the volume of traffic, including at peak times, on our Web sites increases, we will need to expand and upgrade our technology, transaction processing systems and network infrastructure. We may not be able to accurately project the rate or timing of these increases, if any, in the use of our services or to expand or upgrade our systems and infrastructure in a timely manner to accommodate these increases.

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We use internally developed systems for operating our services and processing our transactions, including billing and collections processing. We must continually improve these systems in order to accommodate the level of use of our Web sites. In addition, if we add new features and functionality to our services, we could be required to develop or license additional technologies. Our inability to add additional software and hardware or upgrade our technology, transaction processing systems or network infrastructure could cause unanticipated system disruptions, slower response times, degradation in levels of customer support, impaired quality of the users' experience, delays in accounts receivable collection or losses of recorded financial information. Our failure to provide new features or functionality also could result in these consequences. The required hardware may not be readily available or affordable and we may be unable to effectively upgrade and/or expand our systems in a timely manner or to integrate smoothly any newly developed or purchased technologies with our existing systems. These difficulties could harm or limit our ability to expand our business.

### **We could be held liable for products and services referred by means of our Web site.**

We could be subject to claims relating to products and services that we refer through our Web site. Homeowners may bring claims against us for referring service providers who may have, among other things, provided them with poor workmanship or caused bodily injury or damage to property. Our existing insurance coverage may not cover all potential claims, may not adequately cover all costs incurred in defense of potential claims, may not indemnify us for all liability that may be imposed or may not be renewable in future periods or renewable on terms and conditions satisfactory to us. In addition, claims, with or without merit, would result in diversion of our financial resources and management resources.

### **We depend on the increasing use of the Internet. If the use of the Internet does not grow, our revenues may not grow and could decline and our business could be harmed.**

We depend on increased acceptance and use of the Internet. In particular, our matching service depends upon service providers being willing to use the Internet to find jobs through our service. We believe that service providers generally have not traditionally used computers or the Internet to operate their businesses. Demand and market acceptance for recently introduced products and services over the Internet are subject to a high level of uncertainty. As a result, acceptance and use of the Internet may not develop or a sufficiently broad base of users may not adopt or continue to use the Internet as a medium of commerce.

### **The Internet is characterized by rapidly changing technologies, frequent new product and service introductions and evolving industry standards.**

To succeed, we will need to adapt effectively to rapidly changing technologies and continually improve the performance features and reliability of our services. We could incur substantial costs in modifying our products, services or infrastructure to adapt to these changes, and we may also lose customers and revenues if our services fail to adapt to the rapid changes characteristic of the Internet.

Conversely, if the Internet experiences increased growth in number of users, frequency of use and bandwidth requirements, the Internet infrastructure may be unable to support the demands placed on it. The success of our business will rely on the Internet providing a convenient means of interaction and commerce. Our business depends on the ability of users to access information without significant delays or aggravation.

### **Future government regulations and legal uncertainties pertaining to the Internet could decrease the demand for our services or increase the cost of doing business.**

There is, and will likely continue to be, an increasing number of laws and regulations pertaining to the Internet. These laws and regulations may relate to liability for information retrieved from or transmitted over the Internet, online content, user privacy, taxes or the quality of services. Any new law or regulation pertaining to the Internet, or the adverse application or interpretation of existing laws, could decrease the demand for our services or increase our cost of doing business.

We are not certain how our business may be affected by the application of existing laws governing issues such as property ownership, copyrights, encryption and other intellectual property issues, taxation, libel, obscenity and export or import matters. The vast majority of these laws was adopted prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues created by the Internet and related technologies. Changes in laws intended to address these issues could create uncertainty for or adversely affect companies doing business on the Internet. This could reduce demand for our services or increase the cost of doing business.

### **Legislative and regulatory initiatives regarding the collection and use of our users' personal information may result in liability and expenses.**

Current computing and Internet technology allows us to collect personal information about our users. In the past, the Federal Trade Commission has investigated companies that have sold personal information to third parties without permission or in violation of a stated privacy policy. Currently, we collect personal information only with the users' consent and under our privacy policy. If we begin collecting or

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selling personal information without permission or in violation of our privacy policy, we could face potential liability for compiling and providing information to third parties.

### **The imposition of additional state and local taxes on Internet-based transactions would increase our cost of doing business and harm our ability to become profitable.**

We file state tax returns as required by law based on principles applicable to traditional businesses. However, one or more states could seek to impose additional income tax obligations or sales and use tax collection obligations on out-of-state companies such as ours that engage in or facilitate Internet-based commerce. A number of proposals have been made at state and local levels that could impose taxes on the sale of products and services through the Internet or the income derived from those sales. These proposals, if adopted, could substantially impair the growth of Internet-based commerce and harm our ability to become profitable.

United States federal law limits the ability of the states to impose taxes on Internet-based transactions. Until October 21, 2001, state and local taxes on Internet-based commerce that are discriminatory against Internet access are prohibited, unless the taxes were generally imposed and actually enforced before October 1, 1998. It is possible that this tax moratorium will not be renewed by October 21, 2001 or at all. Failure to renew this legislation would allow various states to impose taxes on Internet-based commerce. The imposition of state and local taxes could harm our ability to become profitable.

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

### **Interest Rate Risk**

The primary objective of ImproveNet's investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash and cash equivalents in a variety of securities, including both government and corporate obligations and money market funds.

Our exposure to market risk for changes in interest rates relates primarily to increases or decreases in the amount of interest income we earn on our investment portfolio and on increases or decreases in the amount of interest expense we must pay with respect to any outstanding debt instruments. We mitigate default risk by investing in only high credit quality securities that we believe to be low risk and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor.

We do not hold derivative financial instruments as of March 31, 2001, and have never held such instruments in the past. In addition, we had no debt instruments outstanding as of March 31, 2001. We currently transact all of our revenues, which are all traded in the United States in U.S. dollars.

## **PART II. OTHER INFORMATION**

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

From time to time, we may be involved in litigation relating to claims arising out of our operations. As of the date of this filing, we are not engaged in any material legal proceedings.

### **Item 2. Changes In Securities and Use of Proceeds**

On March 15, 2000, we commenced the initial public offering of 2,760,000 shares of common stock, par value \$.001 per share, at a price of \$16.00 per share in firm commitment underwritten public offering. The offering was effected pursuant to a Registration Statement on Form S-1 (Registration Nos. 333-92873 and 333-32618), which the United States Securities and Exchange Commission declared effective on March 15, 2000. Credit Suisse First Boston, Robertson Stephens and E\*Offering were the lead underwriters for the offering.

Of the \$44.2 million in aggregate proceeds we raised in the offering, \$3.1 million was paid to underwriters in connection with the underwriting discount, and approximately \$1.4 million was paid by us in connection with offering expenses, printing fees, filing fees, legal fees and accounting fees.

Prior to the public offering, we had cash and cash equivalents of \$45.3 million at December 31, 1999. As of March 31, 2000, we had cash and cash equivalents of \$69.0 million, inclusive of the proceeds of the offering.

Since March 31, 2000, we have used the proceeds of the offering and proceeds from prior private offerings of approximately \$44.6 million for operating activities, and approximately \$3.6 million for capital expenditures, offset by cash generated from financing activities. As of March 31, 2001, we have cash of approximately \$22.1 million for operating activities, capital expenditures, as well as for other corporate

purposes.

**Item 3. Defaults Upon Senior Securities**

None

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

No matters were submitted to a vote of security holders during the first quarter of our fiscal year ended December 31, 2001.

**Item 5. Other Information**

On March 29,2001 ImproveNet announced the Board's approval of a stock repurchase plan. The plan allows for the purchase of up to \$2 million in common stocks. To date, no purchase have been made.

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

Exhibit  
Number Description of Document

3.1**	Form of Third Amended and Restated Certificate of Incorporation of the Registrant.
3.2**	Fourth Amended and Restated Certificate of Incorporation of the Registrant.
3.3**	Bylaws of the Registrant.
3.4**	Amended and Restated Bylaws of the Registrant.
4.1**	Specimen Stock Certificate.
4.2**	Reference is made to Exhibits 3.1, 3.2, 3.3 and 3.4 hereof.
10.1**	Amended and Restated 1996 Stock Option Plan.
10.2**	Form of 1999 Equity Incentive Plan.
10.3**	Form of 1999 Employee Stock Purchase Plan.
10.4**	Commercial Office Lease by and between Florcor I Limited Partnership and the Registrant.
10.5**	Commercial Office Lease by and between Chestnut Bay LLC and the Registrant.
10.6**	Employment agreement by and between the Registrant and Ronald Cooper.
10.16**	Internet-based Service Agreement between the Registrant and Owens Corning dated October 1, 1999.
10.17**	Collaboration Agreement between the Registrant and E.I. du Pont de Nemours and Company dated December 3, 1999.
10.18**	Internet Development, Marketing and Distribution Agreement between the Registrant and General Electric Appliances dated September 10, 1999.
10.19**	Relationship Agreement between the Registrant and Microsoft HomeAdvisor dated December 7, 1999.

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10.20\*\* Agreement between the Registrant and CompleteHome Operations, Inc. dated December 13, 1999.

10.21\*\* Form of 1996 Stock Option Plan Grant Notice.

10.22\*\* Form of 1999 Equity Incentive Plan Stock Option Agreement.

10.34\*\* Promissory Note and Stock Pledge Agreement between ImproveNet, Inc. and Ronald B. Cooper dated April 14, 2000

10.35\*\* Commercial Office Lease by and between Bennett Center, LLC and the Registrant

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\*\* Previously Filed

(b) No reports on Form 8-K were filed with the Securities and Exchange Commission during the three months ended March 31, 2001.

Signatures

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed, May 14, 2001 on its behalf by the undersigned duly authorized.

IMPROVENET, INC.  
(Registrant)

By:/s/ Ronald Cooper

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Ronald Cooper  
Chairman, CEO & President

By:/s/ Michael Cribbin

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Michael Cribbin  
VP of Finance  
(Principal Accounting & Financial Officer)

Date: May 14, 2001

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