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INVESTMENT THESIS

LONG: ZipRealty, Inc. (ZIPR: $2.79)

Company	ZipRealty, Inc.	**Price/Revs FY1 (Consensus)**	0.5x	**YTD % Change**	5.3%
Ticker	ZIPR	**Price/Revs FY2 (Consensus)**	0.4x	**52 Week High**	5.28
Stock Price	$2.79	**FY1 EV/EBITDA**	N/A	**52 Week Low**	2.01
Mkt Cap	57	**FY2 EV/EBITDA**	6.5x	**200-Day**	3.14
Enterprise Value	7	**FCF Yield (Trailing)**	N/A	**50-Day**	2.58
Net Debt	-49	**ROE**	N/A	**RSI**	51.69
Credit Ratings	N/A	**ROIC**	N/A	**Avg. Daily Vol. (000s)**	7.7
Cash/Share	$2.46	**Dividend Yield**	N/A		

Investment Thesis Overview:

In late 2002, we ran a screen to identify companies that had outstanding balance sheets (cash in excess of 50% of market cap), a total market cap of less than $250 million, positive revenue growth for a minimum of three consecutive years, a price/revenue multiple of less than 1.0x and a few other criteria. It turned out that this particular screen unearthed some of the highest returning investment ideas of our careers. We recently ran a similar screen, which not surprisingly returned a number of names. One of the names that stood out to us was ZipRealty, Inc., the 9th largest residential real estate brokerage firm in the U.S. We are increasingly confident that a floor in housing VOLUMES has been reached; price discovery in many markets is still ongoing. We think ZIPR could represent a good way to play a housing recovery; the stock is cheap and it has underperformed almost all of the housing related stocks. Our thesis is based on the following:

1. **ZIPR is well positioned in California, now the fastest growing residential real estate market in the country**. We estimate approximately 20-25% of ZIPR's agents are based in California. Over the past 6-9 months, the residential real estate market in California has finally reached a point where affordability has trumped concerns about the economy and credit availability issues. According to the California Association of Realtors, single family home sales increased more than 60% in March, spurred by a 50% decline in prices over the past 2-years.
2. **ZipRealty is gaining market share**. ZipRealty is now the 9th largest residential real estate brokerage firm in the country. The company increased revenues 3.5% and closed transactions 22.9% last year in the worst housing market in the past 50-years. The company achieved growth through greenfield expansion into new markets and through increased lead flow generated from its website. Ziprealty.com generates approximately 2.0 million unique visitors a month, more than Century21.com, remax.com, and coldwellbanker.com
3. **We expect operating losses from operations in new markets to decline over the next 12-24 months as housing volumes stabilize and recently hired agents increase productivity.** Over the past two years, ZIPR has entered 12-new markets. It typically takes the company 2-3 years to achieve a critical mass of agents, listings, and brand awareness to achieve profitability at the market

Disclaimer: The author of this report owns shares in ZIPR, positions can change at any time without notice.

level. In 2008, the company generated $3.0 million in losses from new markets. We expect those markets to reduce losses in 2009 and then turn to profitability in 2010.

4. **ZIPR has an outstanding balance sheet.** As of 12/31/08, ZIPR had $49.4 million in cash and no debt. Stated another way, the market has afforded a total enterprise value to ZipRealty of $7 million, despite the company's huge presence on the internet and its track record of profitability in established markets. We think ZIPR represents an excellent acquisition candidate given its growing brand and exquisite balance sheet. Alternatively, we think ZIPR's cash position will enable the company to pursue acquisitions or stock repurchases as the path to profitability becomes increasingly clear.

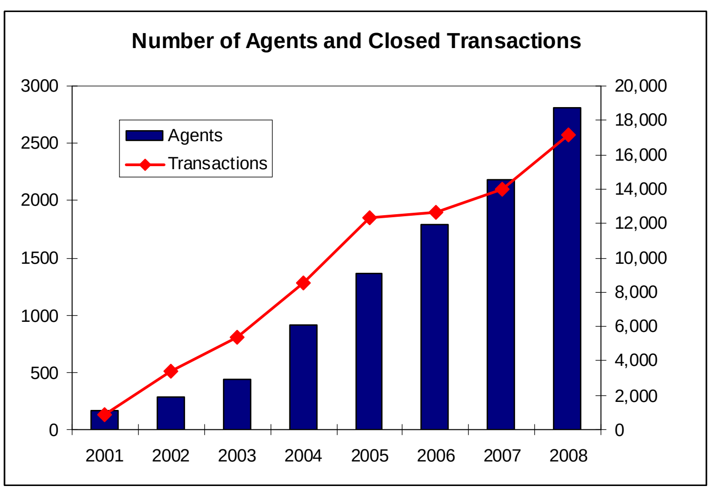
RISKS:

The risks to our investment thesis are the following:

1. ZIPR shares are highly illiquid. The stock only trades approximately 8,000 shares a day, so getting into and out of a position can be problematic to say the least. This stock is truly only for the "Buy and hold" crowd.
2. The average agent at ZipRealty does not make as much as he or she could at a traditional brokerage firm, which as increased turnover. Management has taken steps to improve the economics for agents, but turnover levels could remain high if agent productivity does not improve.
3. Transaction volumes in California could decline from current levels, while prices remain depressed. We estimate that ZIPR generates approximately 25-35% of its revenues from California.

BRIEF COMPANY DESCRIPTION AND TRADING HISTORY

According to Real Trends, ZipRealty is the 9th largest residential real estate brokerage firm in the U.S. The company now has more than 2,800 agents in 35 markets across the country. From 2006 to 2008, ZipRealty completed a massive geographic expansion plan, which effectively doubled the number of markets in which the company had a presence and increased its agent network by 50%.



As of 12/31/08

New Markets	Open	Existing Markets
Naples, FL	Mar-07	Atlanta, GA
Tucson, AZ	Mar-07	Austin, TX
Denver, CO	Apr-07	Baltimore, MD
Jacksonville, FL	May-07	Boston, MD
Salt Lake City, UT	Jul-07	Chicago, IL
Richmond, VA	Jul-07	Dallas, TX
Virginia Beach, VA	Aug-07	Fresno, CA
Charlotte, NC	Aug-07	Houston, TX
Raleigh Durham, NC	Sep-07	Las Vegas, NV
Westchester County, NY	Dec-07	Los Angeles, CA
Long Island, NY	Mar-08	Miami, FL
Hartford, CT	Jul-08	Minneapolis, MN
		Orange County, Ca
		Orlando, FL
		Palm Beach, FL
		Philadelphia, PA
		Phoenix, AZ
		Sacremento, CA
		San Diego, CA
		San Fran, CA
		Seattle, WA
		Tampa, FL
		Washington D.C.

Source: Company reports

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ZipRealty – A full service brokerage firm offering a discount to buyers and a superior online experience

Ziprealty has differentiated itself in the $49 billion residential real estate brokerage industry by delivering a superior online experience to customers and offering a 20% commission discount to buyers and a 25% discount to sellers. Through ziprealty.com, the company provides its customers with unrestricted access to MLS data and proprietary market information. ZIPR's goal is to streamline the transaction process by using the internet to help reduce overhead and then pass those savings along to consumers in the form of discounts. It is important to note that the company has a limited track record of profitability under this business model.

Company History and Trading Background:

ZipRealty was founded in 1999, as a completely web-based online residential real estate brokerage firm. The company started a more significant agent-hiring push approximately 2-years later. The company's original venture capital investors include: Benchmark Capital, Pyramid Technology, and Vanguard Ventures. ZipRealty completed its IPO in November 2004 at $13/share. There have been a number of management changes at ZipRealty in the past 2-3 years. In early 2006, one of the founders of the company, Eric Danzinger stepped down as CEO. After a year long search process, Pat Lashinsky was appointed CEO in June 2007. He has almost 10-years of experience at the company. ZIPR appointed Lanny Baker, a former Citigroup sell-side research analyst as its CFO in the fourth quarter of 2008.

ZIPR's stock price peaked within a month after its IPO, at approximately $18/share. The stock sold off sharply as the housing bubble burst. Two of the companies original venture capital investors remain large shareholders in the company. Benchmark Capital and Vanguard Venture Partners own 20.6% and 10.7% of the shares outstanding, respectively. In April 2008, ZIPR repurchased approximately 3.5 million shares from Pyramid Technology Ventures at a price of $5.00/share.

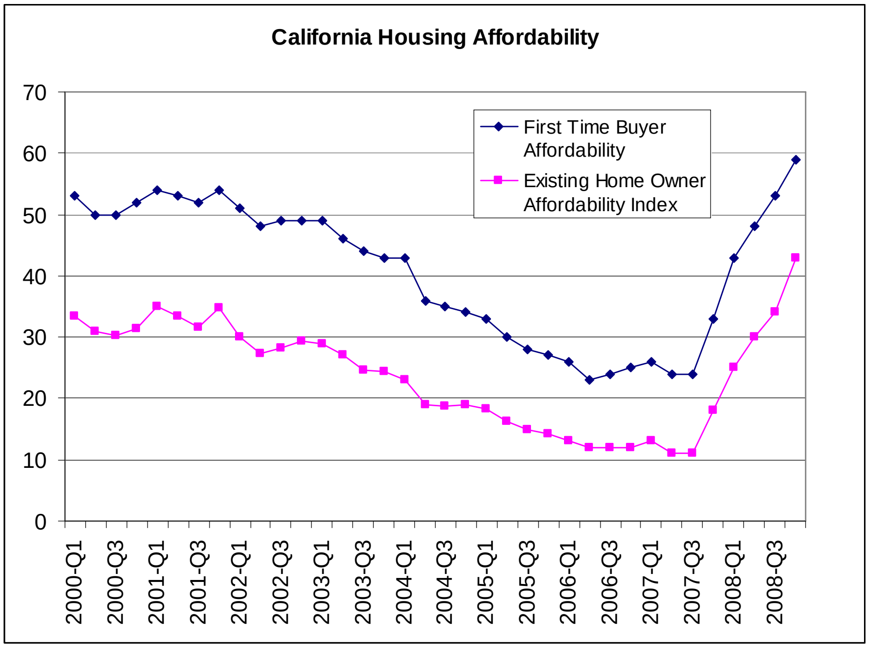
Short Dynamics and Insider Trading
The short interest in ZIPR is sizeable given the liquidity position of the stock. As of 4/15/09 there were 144,000 shares short, which implies a short interest ratio of approximately 16.3 days. The short interest in ZIPR peaked in the first quarter of 2008.

Outside of the repurchase of Pyramid Technology Ventures' ownership interest a year ago, there have not been any meaningful share buybacks or insider transactions over the past 12-months. Recently appointed CFO, Lanny Baker was awarded 325,000 options as part of his employee agreement with a strike price of $2.56. The options vest over a period of four years.

INVESTMENT THESIS IN DETAIL

Our investment thesis is predicated on the following:

1. **ZIPR is well positioned in California, now the fastest growing residential real estate market in the country.** Arizona, California and Florida were the unequivocal epicenters of the housing bubble. Each of these markets is in varying stages of recover, but it has become increasingly clear over the past 6-months that a significant element of price discovery has occurred in California. Brushing off our supply and demand curves from Econ 101, we view price discovery as the process of determining a price at which huge levels of excess inventory in the housing market will be eliminated. In the case of California, a 50%+ reduction in the median home price was required. A huge increase in distressed sales combined with low mortgage rates and first-time home buyer tax credits has created a perfect storm of affordability in California. According to the California Association of Realtors, affordability for existing home owners and first time buyers is now higher than it has been at any other point this decade.



Source: California Association of Realtors

As one would expect, the rapid increase in affordability has more than trumped concerns about the economic environment and credit availability. In the past six months, single family home sales have approached volumes in California not seen since 2005. We anticipate activity will slow down in the back half of the year, but it is increasingly clear that transaction volumes and possibly price have reached some sort of level.

	2003	2004	2005	2006	2007	2008	Jan-09	Feb-09	Mar-09
Single Family Home Sales (000s)	601.8	624.7	625	477.5	346.9	439.8	624.94	620.41	522.98
YOY Change	5.1%	3.8%	0.0%	-23.6%	-27.4%	26.8%	100.8%	83.0%	63.8%
Median Price ($000s)	$371.5	$450.8	$522.7	$556.4	$560.3	$346.4	$254.4	$247.6	$253.0
YOY Change	17.5%	21.3%	15.9%	6.4%	0.7%	-38.2%	-40.5%	-40.8%	-39.0%

Source: California Association of Realtors

We recognize that a significant portion of the increase in sales are REO or foreclosure related, but that does eliminate the economic opportunity for a real estate brokerage firm. ZipRealty has its roots in California. We estimate approximately 20-25% of the company’s agents reside in California. ZIPR now has over a decade of operating experience in the state and significant brand awareness. The company’s robust website functionality and reduced commission rate are likely to offer significant appeal to buyers in search of discounted or foreclosure properties. The company generated a 33% YOY increase in closed transactions in existing markets in 4Q08, which we attribute in large part to the company’s strong presence in California.

2. **ZipRealty is gaining market share**. ZipRealty has increased transaction volumes YOY in each off the last three-quarters, during a period in which new and existing home sales declined 30-40% YOY on average. We attribute the increase in market share to the following factors:

- *Increased geographic expansion*. As previously mentioned, ZIPR has doubled the number of markets it serves over the past three years. The company has still not achieved critical mass in all of its new markets, but overall transactions in new markets were up almost 500% in 2008.
- *Ziprealty.com is a lead generation machine with surging traffic.* ZIPR's website is the single largest reason why prospective agents choose to join the company. The site now generates approximately 2.0 million visitors a month. **Traffic to the site has increased in excess of 50% YOY for each of the past three months**. Historically, traffic data has been a strong leading indicator of transaction volume. Prospective customer's become highly engaged by the depth of data on the site and populate ZIPR's lead database with a great amount of detail about each individual's buying preferences. This ultimately leads to a higher conversion rate, and ideally a better buyer experience.
- *ZipRealty's value based pricing model appeals to those looking for distressed sales.* ZipRealty offers buyers a discount on a home purchase equal to 20% of the commission amount. We think the value proposition resonates more effectively with buyers of foreclosure properties or REO sales.

3. **We expect operating losses from operations in new markets to decline over the next 12-24 months as housing volumes stabilize and recently hired agents increase productivity**. ZipRealty provides financial data on its operations in new and existing markets. Overall, the company's newer markets have contributed substantially to revenue growth, but have reduced profitability significantly. Agent productivity and commissions per transaction are substantially lower in new markets as opposed to the company's existing markets. We estimate the company spends approximately $600-$750K on marketing in the first year of operation in a new market and another $1.0-$1.5 million in overhead. As the table below highlights, the company's existing market operations are solidly profitable. We estimate it takes approximately 24-36 months for ZIPR to establish a firm foothold in a new market and generate profits at the office level.

   Management has stated that it only plans to open operations in 2 new markets in 2009, which will substantially reduce losses. We think this is a prudent strategy at this stage. Improving agent productivity and to the extent necessary agent quality, are the best investments the company can make. We think the company can achieve historical levels of agent productivity (transaction/agent) of 8.0-9.0 per annum, if the number of new market openings remains reduced. From a structural perspective, we think a mature market operates at 15-20% contribution margins (gross profit less attributable marketing expense). At 18-20% contribution margins and a meager 7.5-8.0 transactions per-annum, we think, ZIPR can achieve break-even profitability.

	Existing Markets	New Markets 12/31/2008	New Markets 12/31/2007
Total Markets	23	12	10
Number of Agents	2,212	604	253
Number of Transaction/Agent	6.76x	3.64x	1.51x
Revenue/Transaction	$6,376	$4,571	$4,556
Total Revenues ($000s)	**$95,384**	**$10,043**	**$1,736**
Gross Profit ($000s)	$38,077	$4,648	$819
% of Revenues	39.9%	46.3%	47.2%
Commisson/Agent	$27,691	$12,590	$4,022
Sales & Marketing/Market ($000s)	$1,107	$637	$353
Operating Profit ($000s)	**$12,618**	**-$2,995**	**-$2,709**
Margin	**13.2%**	**-29.8%**	**-156.0%**

Source: Company reports, PAA Research

VARIANCE VS. CONSENSUS

We think ZIPR can achieve profitability by 2010, after which the company will generate significant free cash flow. Here are the key assumptions in our forecast:

- A 5% YOY increase in the number of agents in 2009, which would be a sharp reduction compared to the 20-30% annual growth of the past three years
- A 10% YOY decline in revenue per transaction in 2009 due to the decline in home prices nationally. We expect home prices to become a driver of growth for ZIPR in 3Q10.
- Average number of transactions/agent of 7.75x in 2009 and 8.50x in 2010
- A trough level of cash in 1Q10 of $40 million, or $2.00/share.

	Consensus			PAA Research		
	1Q09E	**FY09E**	**FY10E**	**1Q09E**	**FY09E**	**FY10E**
Revenues	$24.4	$116.5	$133.5	$25.6	$126.7	$150.1
% Change	18.1%	8.4%	14.5%	26.6%	17.9%	18.5%
EPS	-$0.19	-$0.45	-$0.24	-$0.19	-$0.36	$0.08

Source: Yahoo Finance, PAA Research LLC

CATALYSTS

ZipRealty is in no way, shape or form a short term investment idea. However, we expect the company's 1Q09 results could show significant signs of market share gains and further clarify the path to profitability.

1. **1Q09 Earnings (May 7th).** We think shares will respond favorably if

management speaks to the possibility of break even in the second and third quarter, its two strongest seasonally.

2. **Housing data from California and Overall Housing Data.** ZIPR's stock price performance has not been highly correlated with other housing-sensitive names. We attribute this to the lack of liquidity and general interest in the company. However, if the data over the next several months continues to support a floor in home sales volume in California and the rest of the market, we think investors will start to look for other ways to play a housing recovery that have not run as much.

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based not only on current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 70%

A quick look at valuation: ZIPR shares currently trade at a slight premium to its cash balance. Clearly investors have assumed that the company will continue to burn through its cash over the next several years. We estimate the company will start generating positive free cash flow in the second quarter of 2010. Overall, the company now has an enterprise value of $7 million, which we think is absurdly low for a company that generates over $100 million in revenues, has positive contribution margins, and generates 2.0 million unique visitors to its website monthly. **We think ZIPR would be an excellent acquisition candidate.** The stock trades at 0.5x revenue, which is attractive for a service oriented model that has the potential to generate high returns on invested capital.

We think ZIPR shares could trade to $4 by the end of the year: At $4, ZIPR shares would trade at 25x our FY10 EPS estimate of $0.08, plus $2.00/share in cash we expect to remain at year end.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. Overall, we think there's a 70% chance that ZIPR shares will trade higher over the next 9-12 months. In our downside case, ZIPR shares continue to get valued based on the company's cash balances. Overall the probability adjusted return is 43.4%, which we think is compelling for a 9-12 month trade.

Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Total Probability Weighted Return
Upside	$2.79	$5.00	45.0%	79.2%	1.0x	79.2%	43.4%
Base	$2.79	$4.00	25.0%	43.4%	1.0x	43.4%	
Downside	$2.79	$2.50	30.0%	-10.4%	1.0x	-10.4%	

Source: PAA Research LLC

HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: We recommend owning ZIPR shares outright given the huge liquidity mismatch any hedge would have.

Relevant upcoming events:	May 5th	1Q09 Results
Relevant upcoming events:	3rd/4th week of May	CAR Home Sales Data for April
Relevant upcoming events:	May 27th	Existing Home Sales
Relevant upcoming events:	May 28th	New Home Sales