

TRAVELZOO INC
Form 10-Q
April 30, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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, 2012

or

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

For the transition period from to .

Commission File No.: 000-50171

TRAVELZOO INC.

(Exact name of registrant as specified in its charter)

Edgar Filing: TRAVELZOO INC - Form 10-Q

DELAWARE
(State or other jurisdiction of
incorporation or organization)

36-4415727
(I.R.S. employer
identification no.)

590 Madison Avenue, 37th Floor

New York, New York
(Address of principal executive offices)

10022
(Zip code)

Registrant's telephone number, including area code: (212) 484-4900

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of Travelzoo common stock outstanding as of April 27, 2012 was 15,961,553 shares.

Table of Contents

TRAVELZOO INC.

Table of Contents

| | Page |
|--|-------------|
| PART I FINANCIAL INFORMATION | |
| <u>Item 1. Financial Statements (Unaudited)</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of March 31, 2012 and December 31, 2011</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2012 and 2011</u> | 4 |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the Three Months Ended March 31, 2012 and 2011</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2012 and 2011</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 34 |
| <u>Item 4. Controls and Procedures</u> | 34 |
| PART II OTHER INFORMATION | |
| <u>Item 1A. Risk Factors</u> | 34 |
| <u>Item 6. Exhibits</u> | 34 |
| <u>Signature</u> | 36 |

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****TRAVELZOO INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)****(In thousands, except par value)**

| | March 31, 2012 | December 31, 2011 |
|--|---------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 48,559 | \$ 38,744 |
| Accounts receivable, less allowance for doubtful accounts of \$499 and \$400 as of March 31, 2012 and December 31, 2011, respectively | 14,655 | 13,340 |
| Income tax receivable | 2,780 | 3,625 |
| Deposits | 402 | 278 |
| Prepaid expenses and other current assets | 2,444 | 2,123 |
| Deferred tax assets | 1,755 | 1,754 |
| Total current assets | 70,595 | 59,864 |
| Deposits, less current portion | 807 | 776 |
| Deferred tax assets, less current portion | 344 | 344 |
| Restricted cash | 3,097 | 3,103 |
| Property and equipment, net | 3,674 | 3,557 |
| Intangible assets, net | 616 | 704 |
| Total assets | \$ 79,133 | \$ 68,348 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 22,420 | \$ 21,731 |
| Accrued expenses | 12,010 | 6,311 |
| Deferred revenue | 2,316 | 2,168 |
| Income tax payable | | 279 |
| Deferred rent | 99 | 114 |
| Total current liabilities | 36,845 | 30,603 |
| Long-term tax liabilities | 2,276 | 2,225 |
| Deferred rent, less current portion | 712 | 761 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value per share (5,000 shares authorized; none issued) | | |
| Common stock, \$0.01 par value (40,000 shares authorized; 16,462 shares issued and 15,962 shares outstanding as of March 31, 2012 and December 31, 2011) | 164 | 164 |
| Treasury stock (at cost, 500 shares at December 31, 2011) | | (15,123) |
| Additional paid-in capital | 7,943 | 7,656 |

Edgar Filing: TRAVELZOO INC - Form 10-Q

| | | |
|--|-----------|-----------|
| Retained earnings | 32,108 | 43,484 |
| Accumulated other comprehensive loss | (915) | (1,422) |
| Total stockholders' equity | 39,300 | 34,759 |
| Total liabilities and stockholders' equity | \$ 79,133 | \$ 68,348 |

See accompanying notes to unaudited condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| Revenues | \$ 39,333 | \$ 36,960 |
| Cost of revenues | 4,054 | 2,442 |
| Gross profit | 35,279 | 34,518 |
| Operating expenses: | | |
| Sales and marketing | 16,265 | 16,131 |
| General and administrative | 9,444 | 8,394 |
| Unexchanged merger shares | 3,000 | 20,000 |
| Total operating expenses | 28,709 | 44,525 |
| Income (loss) from operations | 6,570 | (10,007) |
| Other income and expense, net | 99 | 63 |
| Income (loss) before income taxes | 6,669 | (9,944) |
| Income taxes | 2,922 | 4,011 |
| Net income (loss) | \$ 3,747 | \$ (13,955) |
| Basic net income (loss) per share | \$ 0.23 | \$ (0.85) |
| Diluted net income (loss) per share | \$ 0.23 | \$ (0.85) |
| Shares used in computing basic net income (loss) per share | 15,962 | 16,451 |
| Shares used in computing diluted net income (loss) per share | 16,019 | 16,451 |

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

TRAVELZOO INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands, except per share amounts)

| | (00,000) Three Months Ended March 31, 2012 | (00,000) 2011 |
|---|--|-------------------------|
| Net income (loss) | \$ 3,747 | \$ (13,955) |
| Other Comprehensive Income: | | |
| Foreign currency translation adjustment | 507 | 222 |
| Total comprehensive income (loss) | \$ 4,254 | \$ (13,733) |

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

| | Three Months Ended March 31, | |
|--|-------------------------------------|------------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 3,747 | \$ (13,955) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 627 | 643 |
| Deferred income tax | | 86 |
| Stock-based compensation | 287 | 187 |
| Provision for losses on accounts receivable | 108 | 18 |
| Tax benefit of stock option exercise | | (268) |
| Net foreign currency effect | (35) | (31) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,271) | (2,918) |
| Deposits | (132) | (561) |
| Income tax receivable | 845 | 264 |
| Prepaid expenses and other current assets | (295) | 193 |
| Accounts payable | 460 | 3,436 |
| Accrued expenses | 5,619 | 23,433 |
| Deferred revenue | 134 | 19 |
| Deferred rent | (75) | 13 |
| Income tax payable | (284) | 89 |
| Other non-current liabilities | 52 | 14 |
| Net cash provided by operating activities | 9,787 | 10,662 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (678) | (699) |
| Net cash used in investing activities | (678) | (699) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | | 40 |
| Tax benefit of stock option exercise | | 268 |
| Net cash provided by financing activities | | 308 |
| Effect of exchange rate changes on cash and cash equivalents | 706 | 243 |
| Net increase in cash and cash equivalents | 9,815 | 10,514 |
| Cash and cash equivalents at beginning of period | 38,744 | 41,184 |
| Cash and cash equivalents at end of period | \$ 48,559 | \$ 51,698 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid (refunded) for income taxes, net | \$ 2,309 | \$ (3,558) |

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

TRAVELZOO INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: The Company and Basis of Presentation

Travelzoo Inc. (the Company or Travelzoo) is a global Internet media company. We inform over 25 million subscribers in North America, Europe and Asia Pacific, as well as millions of website users, about the best travel, entertainment and local deals available from thousands of companies. Our deal experts source, research and test-book offers, recommending only those that meet Travelzoo's rigorous quality standards. We provide travel companies, entertainment companies, and local businesses with a fast, flexible, and cost effective way to reach millions of consumers. Our revenues are generated primarily from advertising fees. In Asia Pacific, the *Travelzoo* business is operated by Travelzoo (Asia) Ltd. and Travelzoo Japan K.K. under a license agreement with Travelzoo Inc.

Our publications and products include the *Travelzoo* websites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, www.travelzoo.de, www.travelzoo.es, www.travelzoo.fr, among others), the *Travelzoo Top 20* e-mail newsletter, the *Newsflash* e-mail alert service, the *SuperSearch* pay-per-click travel search tool, and the *Travelzoo Network*, a network of third-party websites that list travel deals published by Travelzoo. We also operate *Fly.com*, a travel search engine that allows users to quickly and easily find the best prices on flights from hundreds of airlines and online travel agencies. Recently, we launched *Local Deals and Getaways*, new services that allow our subscribers to purchase vouchers for deals from local businesses such as spas, hotels and restaurants through the *Travelzoo* website. Vouchers are redeemable at the local businesses during the promotional period. We receive a percentage of the face value of the voucher from the local businesses.

Starting November 1, 2009, the *Travelzoo* websites in Asia Pacific (cn.travelzoo.com, www.travelzoo.co.jp, www.travelzoo.com.au, www.travelzoo.com.hk, www.travelzoo.com.tw, among others), the *Travelzoo Top 20* e-mail newsletters in Asia Pacific and the *Newsflash* e-mail alert service in Asia Pacific have been published by Travelzoo (Asia) Limited and Travelzoo Japan K.K., wholly owned subsidiaries of Azzurro Capital Inc., under a license agreement with the Company. There is a reciprocal revenue-sharing agreement among the entities operating the *Travelzoo* business in Asia Pacific and the Company related to cross-selling audiences, channels and offers.

Travelzoo is controlled by Ralph Bartel, who held beneficially approximately 53.3% of the outstanding shares as of April 27, 2012.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company, and its results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and related notes as of and for the year ended December 31, 2011, included in the Company's Form 10-K filed with the SEC on February 21, 2012.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. All foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated into U.S. dollars at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated into U.S. dollars at average exchange rates for the period.

The results of operations for the three months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012 or any other future period, and the Company makes no representations related thereto.

The Company was formed as a result of a combination and merger of entities founded by the Company's majority stockholder, Ralph Bartel. In 1998, Mr. Bartel founded Travelzoo.com Corporation, a Bahamas corporation, which issued 5,155,874 shares via the Internet to approximately 700,000 Netsurfer stockholders for no cash consideration, but subject to certain conditions as referred to

Table of Contents

below. In 1998, Mr. Bartel also founded Silicon Channels Corporation, a California corporation, to operate the *Travelzoo* website. During 2001, Travelzoo Inc. was formed as a subsidiary of Travelzoo.com Corporation, and Mr. Bartel contributed all of the outstanding shares of Silicon Channels Corporation to Travelzoo Inc. in exchange for 8,129,273 shares of Travelzoo Inc. and options to acquire an additional 2,158,349 shares at \$1.00. Mr. Bartel exercised these options in January 2009.

In April 2002, Travelzoo.com Corporation was merged into Travelzoo Inc. Under and subject to the terms of the merger agreement, stockholders were allowed a period of two years following the effective date of the merger to receive one share of Travelzoo Inc. in exchange for each outstanding share of common stock of Travelzoo.com Corporation. The records of Travelzoo.com Corporation showed that, assuming all of the shares applied for by the Netsurfer stockholders were validly issued, there were 11,295,874 shares of Travelzoo.com Corporation outstanding. As of April 25, 2004, two years following the effective date of the merger, 7,180,342 shares of Travelzoo.com Corporation had been exchanged for shares of Travelzoo Inc. Prior to that date, the remaining shares which were available for issuance pursuant to the merger agreement were included in the issued and outstanding common stock of Travelzoo Inc. and included in the calculation of basic and diluted earnings per share. After April 25, 2004, the Company ceased issuing shares to the former stockholders of Travelzoo.com Corporation, and no additional shares are reserved for issuance to any former stockholders, because their right to receive shares has now expired. On April 25, 2004, the number of shares reported as outstanding was reduced from 19,425,147 to 15,309,615 to reflect actual shares issued as of the expiration date. Earnings per share calculations reflect this reduction of the number of shares reported as outstanding. As of March 31, 2012, there were 15,961,553 shares of common stock outstanding.

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo which have not been claimed by former stockholders of Travelzoo.com as discussed in the preceding paragraph. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as demandable under Delaware escheat laws. While the Company continues to take the position that such shares were issuable only to persons who establish their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a \$20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims.

During March 2012, the Company became subject to unclaimed property reviews by most of the other states in the U.S. As of March 31, 2012, the firm representing these States in the reviews had presented to the Company preliminary findings which relate primarily to the unexchanged merger shares that were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3 million charge related to this unexchanged merger shares contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged merger shares contingency, the ultimate resolution of this matter, may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company's shares at the end of March 2012, the cost to the Company would be approximately \$20.0 million in excess of the amount accrued. However, the Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company intends to continue to challenge the applicability of escheat rights, in that, among other reasons, the identity, residency, and eligibility of the holders in question cannot be determined. There were certain conditions applicable to the issuance of shares to the Netsurfer stockholders, including requirements that (i) they be at least 18 years of age, (ii) they be residents of the U.S. or Canada, and (iii) they not apply for shares more than once. The Netsurfer stockholders were required to confirm their compliance with these conditions, and were advised that failure to comply could result in cancellation of their shares in Travelzoo.com Corporation. Travelzoo.com Corporation was not able to verify that the applicants met the requirements referred to above at the time of their applications for issuance of shares. If claims are asserted by persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. The Company does not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but the Company believes that only a portion of such requests were valid. In response to the pending reviews referred to above, and in response to other persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares.

The Company is continuing its program under which it makes cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$11,000 for these cash payments for the three months ended March 31, 2012. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. As noted above, in order to receive

Edgar Filing: TRAVELZOO INC - Form 10-Q

payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

Table of Contents**Note 2: Net Income (Loss) Per Share**

Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by adjusting the weighted-average number of common shares outstanding for the effect of dilutive potential common shares outstanding during the period. Potential common shares included in the diluted calculation consist of incremental shares issuable upon the exercise of outstanding stock options calculated using the treasury stock method.

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

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2012 | 2011 |
| Basic net income (loss) per share: | | |
| Net income (loss) | \$ 3,747 | \$ (13,955) |
| Weighted average common shares | 15,962 | 16,451 |
| Basic net income (loss) per share | \$ 0.23 | \$ (0.85) |
| Diluted net income (loss) per share: | | |
| Net income (loss) | \$ 3,747 | \$ (13,955) |
| Weighted average common shares | 15,962 | 16,451 |
| Effect of dilutive securities: stock options | 57 | |
| Diluted weighted average common shares | 16,019 | 16,451 |
| Diluted net income (loss) per share | \$ 0.23 | \$ (0.85) |

For the three months ended March 31, 2012 and 2011, options to purchase 100,000 shares and 300,000 shares, respectively, of common stock were not included in the computation of diluted net income per share because the effect would have been anti-dilutive.

Note 3: Financial Instruments

At March 31, 2012, restricted cash consisted primarily of a certificate of deposit for \$875,000 serving as collateral for a standby letter of credit for the security deposit under the lease of our corporate headquarters and a \$2.2 million deposit with our bank in the U.K. for our merchant account. Cash equivalents consist of highly liquid investments with remaining maturities of three months or less on the date of purchase held in money market funds. The Company believes that the carrying amounts of these financial assets are a reasonable estimate of their fair value and are categorized as level 1. The fair value of these financial assets was determined using the following inputs at March 31, 2012 and December 31, 2011 (in thousands):

| | quoted prices in Total | quoted prices in Fair Value Measurements at Reporting Date Using Quoted Prices in Active Markets for Identical Assets (Level 1) | quoted prices in Reporting Date Using Significant Other Observable Inputs (Level 2) | quoted prices in Significant Unobservable Inputs (Level 3) |
|---------------------------|---------------------------|---|---|--|
| Balance at March 31, 2012 | | | | |
| Money market funds | \$ 9,559 | \$ 9,559 | \$ | \$ |
| Total | \$ 9,559 | \$ 9,559 | \$ | \$ |

Edgar Filing: TRAVELZOO INC - Form 10-Q

Balance at December 31, 2011

| | | | | | | |
|--------------------|----|-------|----|-------|----|----|
| Money market funds | \$ | 5,665 | \$ | 5,665 | \$ | \$ |
| Total | \$ | 5,665 | \$ | 5,665 | \$ | \$ |

At March 31, 2012, cash, accounts receivable and accounts payable are not measured at fair value; however, the Company believes that the carrying amounts of these assets and liabilities are a reasonable estimate of their fair value. Cash is categorized as Level 1 and accounts receivable and accounts payable are categorized as Level 2.

Table of Contents

There have been no changes in Level 1, Level 2 and Level 3 and no changes in valuation techniques for these assets or liabilities for the three months ended March 31, 2012.

Note 4: Intangible Assets

Intangible assets consist of the following (in thousands):

| | March 31, 2012 | December 31, 2011 |
|-------------------------------|-------------------|----------------------|
| Internet domain names | \$ 2,117 | \$ 2,117 |
| Less accumulated amortization | 1,501 | 1,413 |
| Total | \$ 616 | \$ 704 |

Intangible assets have a useful life of 5 years. For the three months ended March 31, 2012 and 2011, amortization expense was \$88,000 for each period.

Future expected amortization expense related to intangible assets at March 31, 2012 is as follows (in thousands):

| | March 31, |
|--------------|---------------|
| 2012 | 266 |
| 2013 | 350 |
| Total | \$ 616 |

The expected amortization expense is an estimate. Actual amounts of amortization expense may differ from estimated amounts due to additional intangible asset acquisitions, impairment of intangible assets, accelerated amortization of intangible assets and other events.

Note 5: Commitments and Contingencies

On August 9, 2011, a purported class action lawsuit in the United States District Court for the Southern District of New York, *Tomlinson v. Travelzoo Inc., et al.*, was commenced against the Company and certain former and current officers and directors. Another putative class action lawsuit, *Steamfitters Local 449 Pension Fund v. Travelzoo Inc., et al.*, was also filed in that court and asserted substantially similar claims against the same defendants. Pursuant to the Private Securities Litigation Reform Act of 1995 (PSLRA), the two putative class action lawsuits will be consolidated and a lead plaintiff will be selected. On January 6, 2012, a Consolidated and Amended Class Action Complaint was filed. The complaint asserts claims under Section 10(b) and 20(a) pursuant to the Securities Exchange Act of 1934 (Exchange Act) alleging that between March 16, 2011 and July 21, 2011, the Company and/or the individual defendants purportedly issued materially false and misleading statements. In particular, the complaint asserts, among other things, allegations challenging certain statements relating to the Company's growth. The complaint also makes allegations regarding the Company's *Getaways* business and asserts that certain officers and directors sold stock while in possession of materially adverse non-public information. The action seeks unspecified damages and we are unable to estimate the possible loss or range of losses that could potentially result from the action. The Company believes that the action is without merit and intends to defend the suits vigorously.

In addition, five shareholder derivative lawsuits, *Wang v. Bartel, et al.*, *Wirth v. Bartel, et al.*, *Kitt v. Bartel, et al.*, *Blatt v. Bartel, et al.*, and *Turansky v. Bartel, et al.*, were filed in the Southern District of New York based on similar allegations that seek to assert claims under state law derivatively on behalf of Travelzoo against certain officers and directors of the Company. The shareholder derivative actions assert that the defendants breached their fiduciary duties under state law by issuing materially false and misleading statements. The actions also allege that certain defendants purportedly sold stock while in possession of material non-public information. The *Kitt* action also includes a claim under Section 14(a) of the Exchange Act that alleges that the Company's May 2, 2011 proxy statement was materially false and misleading. On October 19, 2011, the *Blatt* action was voluntarily dismissed. Plaintiffs in the shareholder derivative actions have moved to consolidate the related actions and to appoint lead counsel and liaison counsel. On January 6, 2012, a Verified Consolidated Shareholder Derivative Complaint

Edgar Filing: TRAVELZOO INC - Form 10-Q

was filed purportedly on behalf of nominal defendant Travelzoo. The complaint asserts claims for breaches of fiduciary duties, unjust enrichment, abuse of control and gross mismanagement against current and former directors and officers of the Company. The complaint also asserts a breach of fiduciary duty claim for insider trading against certain officers and directors, as well as Azzurro Capital, Inc. The derivative action makes allegations regarding the Company's *Getaways* business and asserts that certain officers and directors sold stock while in possession of materially adverse non-public information.

On January 27, 2012, a purported shareholder of Travelzoo commenced a suit in the Supreme Court of New York that allegedly asserts claims derivatively on behalf of Travelzoo Inc. for breaches of fiduciary duty against Travelzoo's board of directors. The complaint also asserts claims for breaches of fiduciary duty and unjust enrichment against Ralph Bartel and Azzurro Capital Inc. The complaint challenges Travelzoo's sale of its Asia Pacific division for \$3.6 million to Azzurro and alleges that the transaction was not entirely fair to the Company.

Table of Contents

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo, which have not been claimed by former stockholders of Travelzoo.com (unexchanged merger shares) as discussed further in Note 1. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as demandable under Delaware escheat laws. While the Company continues to take the position that such shares were issuable only to persons who establish their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a \$20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims.

As discussed in Note 1 above, during March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged merger share, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3 million charge related to this unexchanged merger share contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged merger share contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company's shares at the end of March 2012, the cost to the Company would be approximately \$20.0 million in excess of the amount accrued. However, the Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company is continuing its program under which it makes cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$11,000 for these cash payments for the three months ended March 31, 2012. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending unclaimed property reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received.

The Company leases office space in Canada, France, Germany, Spain, the U.K., and the U.S. under operating leases which expire between April 30, 2012 and March 31, 2022. The future minimum lease payments under these operating leases as of March 31, 2012 total \$12.4 million. The future lease payments consist of \$3,268,000 due in 2012, \$3,298,000 due in 2013, \$1,622,000 due in 2014, \$1,493,000 due in 2015, \$1,137,000 due in 2016, and \$1,534,000 thereafter.

Local Deals and Getaway merchant payable included in accounts payable was \$18.6 million and \$16.0 million, as of March 31, 2012 and December 31, 2011, respectively.

Note 6: Stock-Based Compensation

In November 2009, the Company granted employee options to purchase 300,000 shares of common stock with an exercise price of \$14.97, of which 75,000 options vest and become exercisable annually starting July 1, 2011. The options expire in November 2019. As of March 31, 2012, 75,000 of the options were vested and 300,000 options were outstanding. Total stock-based compensation for the three months ended March 31, 2012 and 2011 was \$187,000 for each period. As of March 31, 2012, there was approximately \$1.7 million of unrecognized stock-based compensation expense related to outstanding stock options. This amount is expected to be recognized over 2.3 years. In January 2012, the Company granted employee options to purchase 100,000 shares of common stock with an exercise price of \$28.98, of which 25,000 options become exercisable annually starting January 23, 2013. The options expire in January 2022. As of March 31, 2012, none of the options were vested and 100,000 options were outstanding. Total stock-based compensation for the three months ended March 31, 2012 was \$99,000. As of March 31, 2012, there was approximately \$1.8 million of unrecognized stock-based compensation expense related to outstanding stock options. This amount is expected to be recognized over 3.8 years. The Company used a forfeiture rate of 0% as the Company does not have enough historical forfeiture data to estimate the forfeiture rate. To the extent the actual forfeiture rate is different from what we have anticipated, stock-based compensation related to these options will be different from our expectations.

Note 7: Income Taxes

In determining the quarterly provisions for income taxes, the Company uses an estimated annual effective tax rate which is based on our expected annual income and statutory tax rates in the U.S. The effective tax rate does not reflect any tax benefits from the losses of our foreign operations. For the three months ended March 31, 2012, the Company's effective tax rate was 44%, which treated the \$3.0 million accrued expense for unexchanged merger shares as having no recognizable tax benefits. For the three months ended March 31, 2011, the Company's effective tax rate was (40)%, which treated the \$20.0 million expense for the settlement with the State of Delaware as having no recognizable tax benefits.

Table of Contents

United States income and foreign withholding taxes have not been provided on undistributed earnings for certain non-U.S. subsidiaries. The undistributed earnings on a book basis for the non-U.S. subsidiaries are approximately \$1.3 million. The Company intends to reinvest these earnings indefinitely in its operations outside the U.S. If the undistributed earnings are remitted to the U.S. these amounts would be taxable in the U.S. at the current federal and state tax rates net of foreign tax credits. Also, depending on the jurisdiction any distribution may be subject to withholding taxes at rates applicable for that jurisdiction.

The Company maintains liabilities for uncertain tax positions. To the extent accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction in the overall income tax provision in the period that such determination is made. At March 31, 2012, the Company had approximately \$1.9 million in total unrecognized tax benefits. Unrecognized tax benefits of approximately \$291,000 which, if recognized, would favorably affect the Company's effective income tax rate, and unrecognized tax benefits of approximately \$1.6 million which if recognized, would be recorded in discontinued operations.

The Company's policy is to include interest and penalties related to unrecognized tax positions in income tax expense. As of March 31, 2012 and December 31, 2011, the Company had approximately \$442,000 and \$391,000, respectively, in accrued interest and penalties related to uncertain tax positions. The Company is in various stages of multiple year examinations by federal and state taxing authorities. Although the timing of resolution and/or closure on audits is highly uncertain, it is reasonably possible that the balance of the gross unrecognized tax benefits related to the method of computing income taxes in certain jurisdiction and losses reported on certain income tax returns could significantly change in the next 12 months. These changes may occur through settlement with the taxing authorities or the expiration of the statute of limitations on the returns filed. The Company is unable to estimate the range of possible adjustments to the balance of the gross unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The Company is subject to U.S. federal and certain state tax examinations for years after 2007 and is subject to California tax examinations for years after 2004.

Note 8: Segments

The Company manages its business geographically and has two reportable operating segments: North America and Europe. North America consists of the Company's operations in Canada and the U.S. Europe consists of the Company's operations in France, Germany, Spain, and the U.K.

Management relies on an internal management reporting process that provides revenue and segment operating income (loss) for making financial decisions and allocating resources. Management believes that segment revenues and operating income (loss) are appropriate measures of evaluating the operational performance of the Company's segments.

The following is a summary of operating results from continuing operations and assets (in thousands) by business segment:

| | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) |
|---|-----------------|-----------------|-------------------|--------------------|---------------------|
| | North | Europe | Other(a) | Elimination | Consolidated |
| Three months ended March 31, 2012: | America | Europe | Other(a) | Elimination | Consolidated |
| Revenues from unaffiliated customers | \$ 28,556 | \$ 10,777 | \$ | \$ | \$ 39,333 |
| Intersegment revenues | 79 | 10 | | (89) | |
| Total net revenues | 28,635 | 10,787 | | (89) | 39,333 |
| Operating income (loss) | \$ 7,142 | \$ 2,428 | \$ (3,000) | | \$ 6,570 |
| | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) |
| | North | Europe | Other(a) | Elimination | Consolidated |
| Three months ended March 31, 2011: | America | Europe | Other(a) | Elimination | Consolidated |
| Revenues from unaffiliated customers | \$ 27,517 | \$ 9,443 | \$ | \$ | \$ 36,960 |
| Intersegment revenues | 101 | 5 | | (106) | |
| Total net revenues | 27,618 | 9,448 | | (106) | 36,960 |

Edgar Filing: TRAVELZOO INC - Form 10-Q

| | | | | | | | | |
|-------------------------|----|-------|----|-----|----|----------|----|----------|
| Operating income (loss) | \$ | 9,252 | \$ | 741 | \$ | (20,000) | \$ | (10,007) |
|-------------------------|----|-------|----|-----|----|----------|----|----------|

(a) Amount represents a charge related to unexchanged merger shares of \$3.0 million and \$20.0 million for the three months ended March 31, 2012 and 2011, respectively.

Table of Contents

| | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) |
|------------------------------|--------------------------|---------------|--------------------|---------------------|
| | North America | Europe | Elimination | Consolidated |
| As of March 31, 2012: | | | | |
| Long-lived assets | \$ 3,669 | \$ 621 | \$ | \$ 4,290 |
| Total assets | \$ 83,245 | \$ 26,558 | \$ (30,670) | \$ 79,133 |

| | \$(99,999) | \$(99,999) | \$(99,999) | \$(99,999) |
|---------------------------------|--------------------------|---------------|--------------------|---------------------|
| | North America | Europe | Elimination | Consolidated |
| As of December 31, 2011: | | | | |
| Long-lived assets | \$ 3,668 | \$ 593 | \$ | \$ 4,261 |
| Total assets | \$ 75,238 | \$ 26,210 | \$ (33,100) | \$ 68,348 |

Revenue for each segment is recognized based on the customer location within a designated geographic region. Property and equipment are attributed to the geographic region in which the assets are located.

For the three months ended March 31, 2012 and 2011, the Company did not have any customers that accounted for 10% or more of revenue. As of March 31, 2012 and December 31, 2011, the Company did not have any customers that accounted for 10% or more of accounts receivable.

The following table sets forth the breakdown of revenues by type and segment for the three months ended March 31, 2012 and 2011. Travel revenue includes travel publications (*Top 20*, *Website*, *Newsflash*, *Travelzoo Network*) and *Getaways* vouchers. Search revenue includes *SuperSearch* and *Fly.com*. Local revenue includes *Local Deals* vouchers and Entertainment.

| | Three Months Ended March 31, | |
|-------------------------------------|--|------------------|
| | 2012 | 2011 |
| | (In thousands, except percentage changes) | |
| North America | | |
| Travel | \$ 15,546 | \$ 16,159 |
| Search | 6,005 | 5,950 |
| Local | 7,005 | 5,408 |
| Total North America revenues | \$ 28,556 | \$ 27,517 |
| Europe | | |
| Travel | \$ 7,393 | \$ 7,333 |
| Search | 1,290 | 958 |
| Local | 2,094 | 1,152 |
| Total Europe revenues | \$ 10,777 | \$ 9,443 |
| Consolidated | | |
| Travel | \$ 22,939 | \$ 23,492 |
| Search | 7,295 | 6,908 |
| Local | 9,099 | 6,560 |
| Total revenues | \$ 39,333 | \$ 36,960 |

Note 9: Related Party Transactions

In July 2010, the Company entered into an independent contractor agreement with Holger Bartel, the Company's former Chief Executive Officer, the Company's Chairman and brother of Ralph Bartel, who controls the Company, to provide consulting services. Fees for these services rendered during the three months ended March 31, 2011 totaled approximately \$164,000. No consulting services were rendered after September 30, 2011, as effective October 1, 2011, Holger Bartel became a full time employee of Travelzoo Inc. pursuant to an employment agreement.

Edgar Filing: TRAVELZOO INC - Form 10-Q

On October 31, 2009, the Company completed the sale of its Asia Pacific operating segment to Azzurro Capital Inc. and its wholly owned subsidiaries, Travelzoo (Asia) Limited and Travelzoo Japan K.K. Azzurro Capital Inc. is owned and controlled by the Ralph Bartel 2005 Trust, on behalf of itself. Ralph Bartel, the Company's principal shareholder, is a Director of the Company and through September 30, 2010 was the Company's Chairman. Mr. Bartel is a member of the board of directors of Azzurro Capital Inc. and is currently the sole beneficiary of the Ralph Bartel 2005 Trust. The Company's receivables from Travelzoo (Asia) Limited and Travelzoo Japan K.K. totaled \$597,000 and \$422,000 as of March 31, 2012 and December 31, 2011, respectively, and were related primarily to fees under a Hosting Agreement and a Referral Agreement entered into in connection with the sale transaction. The \$597,000 and \$422,000 are part of prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets.

Table of Contents

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

The information in this report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements are based upon current expectations, assumptions, estimates and projections about Travelzoo and our industry. These forward-looking statements are subject to the many risks and uncertainties that exist in our operations and business environment that may cause actual results, performance or achievements of Travelzoo to be different from those expected or anticipated in the forward-looking statements. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. For example, words such as may, will, should, estimates, predicts, potentially continue, strategy, believes, anticipates, plans, expects, intends, and similar expressions are intended to identify forward-looking statements. Travelzoo's actual results and the timing of certain events could differ significantly from those anticipated in such forward-looking statements. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those discussed elsewhere in this report in the section entitled Risk Factors and the risks discussed in our other SEC filings. The forward-looking statements included in this report reflect the beliefs of our management on the date of this report. Travelzoo undertakes no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other circumstances occur in the future.

Overview

Travelzoo Inc. (the Company, or Travelzoo) is a global Internet media company. We inform over 25 million subscribers in North America, Europe and Asia Pacific, as well as millions of website users, about the best travel and entertainment deals available from thousands of companies. Our deal experts source, research and test-book offers, recommending only those that meet Travelzoo's rigorous quality standards. We provide travel companies, entertainment companies and local businesses with a fast, flexible, and cost-effective way to reach millions of consumers. Our revenues are generated primarily from advertising fees. In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Ltd. and Travelzoo Japan K.K. under a License agreement with Travelzoo Inc.

Our publications and products include the Travelzoo websites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, www.travelzoo.de, www.travelzoo.es, www.travelzoo.fr, among others), the Travelzoo Top 20 e-mail newsletter, and the Newsflash e-mail alert service. We operate SuperSearch, a pay-per-click travel search tool, and the Travelzoo Network, a network of third-party websites that list deals published by Travelzoo. We also operate Fly.com, a travel search engine that allows users to quickly and easily find the best prices on flights from hundreds of airlines and online travel agencies. Recently, we launched Local Deals and Getaways, new services that allow our subscribers to purchase vouchers for deals from local businesses such as spas, hotels and restaurants through the Travelzoo website. Vouchers are redeemable at the local businesses during the promotional period. We receive a percentage of the face value of the voucher from the local businesses.

On October 31, 2009, we completed the sale of our Asia Pacific operating segment to Azzurro Capital Inc. and its wholly-owned subsidiaries, Travelzoo (Asia) Limited and Travelzoo Japan K.K. We have not had significant ongoing involvement with the operations of the Asia Pacific operating segment and have not had material economic interests in the Asia Pacific operating segment since the completion of the sale. Starting November 1, 2009, the Travelzoo websites in Asia Pacific (cn.travelzoo.com, www.travelzoo.co.jp, www.travelzoo.com.au, www.travelzoo.com.hk, www.travelzoo.com.tw, among others), the Travelzoo Top 20 e-mail newsletters in Asia Pacific and the Newsflash e-mail alert service in Asia Pacific have been published by Travelzoo (Asia) Limited and Travelzoo Japan K.K., under a license agreement with the Company. There is a reciprocal revenue-sharing agreement among the entities operating the Travelzoo business in Asia Pacific and the Company related to cross-selling audiences, channels and offers.

More than 2,000 companies use our services, including American Airlines, Avis Rent A Car, British Airways, Harrah's Entertainment, Expedia, Fairmont Hotels and Resorts, Interstate Hotels & Resorts, JetBlue Airways, Kimpton Hotels, Liberty Travel, Marriott Hotels, Royal Caribbean, Spirit Airlines, Starwood Hotels & Resorts Worldwide, United Airlines, and Virgin Atlantic.

We have two operating segments based on geographic regions: North America and Europe. North America consists of our operations in Canada and the U.S. Europe consists of our operations in France, Germany, Spain, and the U.K. For the three months ended March 31, 2012, European operations were 27% of revenues. Financial information with respect to our business segments and certain financial information about geographic areas appears in Note 12 to the accompanying consolidated financial statements.

When evaluating the financial condition and operating performance of the Company, management focuses on financial and non-financial indicators such as growth in the number of subscribers to the Company's newsletters and page views of the homepages of the Travelzoo websites, operating margin, growth in revenues in the absolute and relative to the growth in reach of the Company's publications measured as revenue per subscriber and revenue per employee as a measure of productivity.

Table of Contents

How We Generate Revenue

Our revenues are advertising revenues, consisting primarily of listing fees paid by travel companies, entertainment companies and local businesses to advertise their offers on Travelzoo's media properties. Listing fees are based on audience reach, placement, number of listings, number of impressions, number of clicks, number of referrals, or percentage of the face value of vouchers sold. Insertion orders are typically for periods between one month and twelve months and are not automatically renewed. Merchant agreements for *Local Deals and Getaways* advertisers are typically for the voucher redemption period, which normally is between three months and twelve months and are not automatically renewed. We have three separate groups of our advertising products; Travel, Search and Local.

Our Travel category of revenue includes the publishing revenue for negotiated high-quality deals from travel companies, such as hotels, airlines, cruises or car rentals and includes products such as *Top 20, Website, Newsflash, Travelzoo Network* as well as *Getaways* vouchers. The revenues generated from these products are based upon a fee for number of e-mails delivered to our audience, a fee for clicks delivered to the advertisers, a fee for placement of the advertising on our website or a fee based on a percentage of the face value of vouchers sold. We recognize revenue upon delivery of the e-mails, delivery of the clicks, over the period of placement of the advertising and upon the sale of the vouchers.

Our Search category of revenue includes comparison shopping tools for consumers to quickly and easily compare airfares, hotel and car rental prices and includes *SuperSearch* and *Fly.com* products. The revenues generated from these products are based upon a fee for clicks delivered to the advertisers or a fee for clicks delivered to advertisers that resulted in revenue for advertisers (i.e. successful clicks). We recognize revenue upon delivery of the clicks or successful clicks.

Our Local category of revenue includes the publishing revenue for negotiated high-quality deals from local businesses, such as restaurants, spas, shows, and other activities and includes *Local Deals* vouchers and entertainment offers (vouchers and direct bookings). The revenues generated from these products are based upon a percentage of the face value of vouchers or items sold or a fee for clicks delivered to the advertisers. We recognize revenue upon the sale of the vouchers, when we receive notification of the direct bookings or upon delivery of the clicks. The Company earns a fee for acting as an agent in these transactions which is recorded on a net basis and is included in revenue upon completion of the voucher sale. Certain merchant contracts in foreign locations allow us to retain fees related to vouchers sold that are not redeemed by purchasers upon expiration, which we recognize as revenue after the expiration of the redemption period and after there are no further obligations to provide funds to merchants, subscribers or others.

Trends in Our Business

Our ability to generate revenues in the future depends on numerous factors such as our ability to sell more advertising to existing and new advertisers, our ability to increase our audience reach and advertising rates and our ability to develop and launch new products.

Our current revenue model depends on advertising fees paid primarily by travel, entertainment and local companies. A number of factors can influence whether current and new advertisers decide to advertise their offers with us. We have been impacted and expect to continue to be impacted by external factors such as the shift from offline to online advertising, the relative health of the economy, competition and the introduction of new methods of advertising. For example, the consolidation of the airline industry reduced our revenues generated from this sector, the introduction of a new voucher-based product offered by competitive companies impacted our ability to sell our existing advertising products, the willingness of certain competitors to grow their business unprofitably and the economic uncertainty in Europe impacted advertiser's willingness to purchase our advertising. In addition, we have been impacted and expect to continue to be impacted by internal factors such as introduction of new advertising products, hiring and relying on key employees for the continued maintenance and growth of our business and ensuring our advertising products continue to attract the audience that advertisers desire.

Existing advertisers may shift from one advertising service (e.g. *Top 20*) to another (e.g. *Local Deals* and *Getaways*). These shifts between advertising services by advertisers could result in no incremental revenue or less revenue than in previous periods depending on the amount purchased by the advertisers, and in particular with *Local Deals* and *Getaways*, depending on how many vouchers are purchased by subscribers.

Our ability to continue to generate advertising revenue depends heavily upon our ability to maintain and grow an attractive audience to reach with our advertising publications. We monitor our subscribers and page views of our websites to assess our efforts to maintain and grow our audience reach. We obtain additional subscribers and activity on our websites by acquiring traffic from internet search companies. The costs to grow our audience have had, and we expect will continue to have, a significant impact on our financial results and can vary from period to period. We may have to increase our expenditures on acquiring traffic to continue to grow or maintain our reach of our publications due to competition.

Edgar Filing: TRAVELZOO INC - Form 10-Q

We believe that we can increase our advertising rates only if the reach of our publications increases. We do not know if we will be able to increase the reach of our publications. If we are able to increase the reach of our publications, we still may not be able to or want to increase rates given market conditions such as intense competition in our industry. We have not had any significant rate increase in recent years due to intense competition in our industry. Even if we increase our rates, based upon the increased price this may reduce the amount of advertisers willing to advertise for the increased rates and therefore decrease our revenue.

Table of Contents

We do not know what our cost of revenues as a percentage of revenues will be in future periods. Our cost of revenues will increase if the number of searches performed on *Fly.com* increases because we pay a fee based on the number of searches performed on *Fly.com*. Our cost of revenues will increase if the face value of vouchers that we sell for *Local Deals* and *Getaways* increases because we have credit card fees based upon face value of vouchers sold, customer service costs related to vouchers sold and subscriber refunds on vouchers sold. We expect fluctuations of cost of revenues as a percentage of revenues from quarter to quarter. Some of the fluctuations may be significant and have a material impact on our results of operations.

We do not know what our sales and marketing expenses as a percentage of revenue will be in future periods. Increased competition in our industry may require us to increase advertising for our brand and for our products. In order to increase the reach of our publications, we have to acquire a significant number of new subscribers in every quarter and continue to promote our brand. One significant factor that impacts our advertising expenses is the average cost per acquisition of a new subscriber. Increases in the average cost of acquiring new subscribers may result in an increase of sales and marketing expenses as a percentage of revenue. We believe that the average cost per acquisition depends mainly on the advertising rates which we pay for media buys, our ability to manage our subscriber acquisition efforts successfully, and the degree of competition in our industry. We may decide to accelerate our subscriber acquisition for various strategic and tactical reasons and, as a result, increase our marketing expenses. We may see a unique opportunity for a brand marketing campaign that will result in an increase of marketing expenses. Further, we expect our strategy to replicate our business model in selected foreign markets to result in a significant increase in our sales and marketing expenses and have a material adverse impact on our results of operations. Due to the continued desire to grow our business both in the North America and Europe we expect relatively high level of sales and marketing expense in the foreseeable future. We expect fluctuations of sales and marketing expenses as a percentage of revenue from year to year and from quarter to quarter. Some of the fluctuations may be significant and have a material impact on our results of operations.

We do not know what our general and administrative expenses as a percentage of revenue will be in future periods. There may be fluctuations that have a material impact on our results of operations. We expect our headcount to continue to increase in the future. The Company's headcount is one of the main drivers of general and administrative expenses. Therefore, we expect our absolute general and administrative expenses to continue to increase. We expect our continued expansion into foreign markets to result in a significant additional increase in our general and administrative expenses. Our general and administrative expenses as a percentage of revenue may also fluctuate depending on the number of requests received related to a program under which the Company intends to make cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert shares into Travelzoo Inc. within the required time period.

We do not know what our income taxes will be in future periods. There may be fluctuations that have a material impact on our results of operations. Our income taxes are dependent on numerous factors such as the geographic mix of our taxable income, federal and state and foreign country tax law and regulations and changes thereto, the amount of accumulated net operating loss we have to offset current taxable income, the determination of whether valuation allowances for certain tax assets are required or not, audits of prior year's tax returns resulting in adjustments, resolution of uncertain tax positions and different treatment for certain items for tax versus books such as our disposition our Asia business in 2009 or our State of Delaware settlement during 2011. We expect fluctuations of in our income taxes from year to year and from quarter to quarter. Some of the fluctuations may be significant and have a material impact on our results of operations.

Our growth strategy key elements include building strong brand awareness, increasing reach, maintaining a high-quality user base, increasing the number of advertisers, providing advertisers with excellent service and replicating our business model in foreign markets. We expect to continue our efforts to grow; however, we may not grow or we may experience slower growth. Some recent examples of our efforts to expand our business internationally since our inception from the U.S. have been expansion to the U.K. in 2005, Canada in 2006, Germany in 2006, France in 2007 and Spain in 2008. We also have launched new products to grow our revenue such as the introduction of *Fly.com* in 2009 *Local Deals* in 2010, *Getaways* in 2011 as well as our mobile application launches in 2011.

We believe that we can sell more advertising only if the market for online advertising continues to grow and if we can maintain or increase our market share. We believe that the market for advertising continues to shift from offline to online. We do not know if we will be able to maintain or increase our market share. We do not know if we will be able to increase the number of advertisers in the future. We do not know if we will have market acceptance of our new products.

Table of Contents**Results of Operations**

The following table sets forth, as a percentage of total revenues, the results from our operations for the periods indicated.

| | Three Months Ended March 31, | |
|--|---|----------------|
| | 2012 | 2011 |
| Revenues | 100.0% | 100.0% |
| Cost of revenues | 10.3 | 6.6 |
| Gross profit | 89.7 | 93.4 |
| Operating expenses: | | |
| Sales and marketing | 41.4 | 43.6 |
| General and administrative | 24.0 | 22.7 |
| Unexchanged merger shares | 7.6 | 54.1 |
| Total operating expenses | 73.0 | 120.4 |
| Income (loss) from operations | 16.7 | (27.0) |
| Other income and expenses, net | 0.3 | 0.2 |
| Income (loss) before income taxes | 17.0 | (26.8) |
| Income taxes | 7.5 | 10.9 |
| Net income (loss) | 9.5% | (37.7)% |

Operating Metrics

The following table sets forth operating metrics in North America and Europe for the three months ended March 31, 2012, and 2011:

| | Three Months Ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| North America | | |
| Total Subscribers | 15,841,000 | 14,818,000 |
| Page views of homepages of Travelzoo website(2) | 8,622,000 | 10,422,000 |
| Average cost per acquisition of a new subscriber | \$ 0.62 | \$ 1.74 |
| Revenue per employee (3) | \$ 497 | \$ 589 |
| Revenue per subscriber(4) | \$ 7.29 | \$ 7.71 |
| Europe | | |
| Total Subscribers | 5,979,000 | 5,125,000 |
| Page views of homepages of Travelzoo websites(2) | 4,168,000 | 6,354,000 |
| Average cost per acquisition of a new subscriber | \$ 1.90 | \$ 3.14 |
| Revenue per employee (3) | \$ 332 | \$ 347 |
| Revenue per subscriber(4) | \$ 7.42 | \$ 8.19 |
| Consolidated | | |
| Total Subscribers(1) | 21,820,000 | 19,943,000 |
| Page views of homepages of Travelzoo websites(2) | 12,790,000 | 16,776,000 |

Edgar Filing: TRAVELZOO INC - Form 10-Q

| | | | | |
|--|----|------|----|------|
| Average cost per acquisition of a new subscriber | \$ | 1.05 | \$ | 2.28 |
| Revenue per employee (3) | \$ | 437 | \$ | 499 |
| Revenue per subscriber(4) | \$ | 7.33 | \$ | 7.80 |

- (1) In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Ltd. and Travelzoo Japan K.K. under a license agreement with Travelzoo Inc. These total subscriber amounts exclude Asia Pacific subscribers of 3,200,000 and 3,000,000 for the three months ended March 31, 2012 and 2011, respectively.
- (2) The comparability of year-over-year changes of page views of the homepages of Travelzoo websites may be limited due to the design and navigation of the websites.
- (3) Annualized revenue divided by number of employees at the end of the quarter.
- (4) Annualized revenue divided by number of subscribers at the beginning of the year.

Table of Contents**Revenues**

The following table sets forth the breakdown of revenues by type and segment for the three months ended March 31, 2012 and 2011. Travel revenue includes travel publications (*Top 20*, *Website*, *Newsflash*, *Travelzoo Network*) and *Getaways* vouchers. Search revenue includes *SuperSearch* and *Fly.com*. Local revenue includes *Local Deals* vouchers and Entertainment.

| | Three Months Ended March 31, | |
|-------------------------------------|--|------------------|
| | 2012 | 2011 |
| | (In thousands, except percentage changes) | |
| North America | | |
| Travel | \$ 15,546 | \$ 16,159 |
| Search | 6,005 | 5,950 |
| Local | 7,005 | 5,408 |
| Total North America revenues | \$ 28,556 | \$ 27,517 |
| Europe | | |
| Travel | \$ 7,393 | \$ 7,333 |
| Search | 1,290 | 958 |
| Local | 2,094 | 1,152 |
| Total Europe revenues | \$ 10,777 | \$ 9,443 |
| Consolidated | | |
| Travel | \$ 22,939 | \$ 23,492 |
| Search | 7,295 | 6,908 |
| Local | 9,099 | 6,560 |
| Total revenues | \$ 39,333 | \$ 36,960 |

North America

North America revenues increased \$1.0 million for the three months ended March 31, 2012 from the three months ended March 31, 2011. This increase was primarily due to growth of Local revenues offset by a decrease in Travel revenue. The increase in Local revenue of \$1.6 million was primarily due to the increased number of *Local Deals* sold. The decrease in Travel revenue of \$613,000 was primarily due to lower *Top 20* and *Newsflash* revenue related to airline consolidation and increased competition offset by an increase in revenue from *Getaways* due to increased number of *Getaways* sold.

Europe

Europe revenues increased \$1.3 million for the three months ended March 31, 2012 from the three months ended March 31, 2011. This increase was primarily due to growth of Local and Search revenues. The increase in Local revenue of \$942,000 was primarily due to the increased number of *Local Deals* sold. The increase in Search revenue of \$332,000 was primarily due to the increased number of clicks that generate revenue as a result from increased spending on traffic acquisition.

For the three months ended March 31, 2012 and March 31, 2011, none of our customers accounted for 10% or more of our revenue.

Foreign currency movements relative to the U.S. dollar negatively impacted our revenues from our operations in Europe by approximately \$277,000 for the three months ended March 31, 2012. Foreign currency movements relative to the U.S. dollar positively impacted our revenues from our operations in Europe by approximately \$131,000 for the three months ended March 31, 2011.

Cost of Revenues

Edgar Filing: TRAVELZOO INC - Form 10-Q

Cost of revenues consists primarily of network expenses, including fees we pay for co-location services and depreciation and maintenance of network equipment, payments made to third-party partners of the *Travelzoo Network*, fees we pay related to user searches on *Fly.com*, amortization of capitalized website development costs, credit card fees, certain estimated subscriber refunds and customer service costs associated with vouchers we sell, and salary expenses associated with network operations and customer service staff. Cost of revenues were \$4.1 million and \$2.4 million for the three months ended March 31, 2012 and 2011, respectively.

Table of Contents

Cost of revenue increased \$1.7 million for the three months ended March 31, 2012 from the three months ended March 31, 2011. This increase was primarily due to an increase in *Local Deals* and *Getaways* costs including \$577,000 in subscriber refunds and \$363,000 in credit card fees, a \$213,000 increase in salary and employee related expenses due primarily to an increase in customer service headcount. In addition, there was an increase of \$177,000 in payments made to third-party partners of the *Travelzoo Network*.

Operating Expenses***Sales and Marketing***

Sales and marketing expenses consist primarily of advertising and promotional expenses, salary expenses associated with sales, marketing and production staff, expenses related to our participation in industry conferences, and public relations expenses. Sales and marketing expenses was \$16.3 million and \$16.1 million for the three months ended March 31, 2012 and March 31, 2011, respectively. For the three months ended March 31, 2012 and 2011, advertising expenses accounted for 38% and 53%, respectively, of total sales and marketing expenses and consisted primarily of online advertising referred to as traffic acquisition cost and subscriber acquisition costs. The goal of our advertising was to acquire new subscribers for our e-mail products, increase the traffic to our websites, and increase brand awareness.

Sales and marketing expenses increased \$134,000 for the three months ended March 31, 2012 from the three months ended March 31, 2011. The increase was primarily due to a \$1.7 million increase in salary and employee related expenses due primarily to an increase in headcount, a \$965,000 increase in Search traffic acquisition costs, offset by a \$2.5 million decrease in subscriber acquisition costs. Despite reduced subscriber acquisition spending, we believe we continued to add new subscribers due to factors such as our website requiring visitors to subscribe in order to be able to view most deals and the traffic associated with *Local Deals* and *Getaways*.

General and Administrative

General and administrative expenses consist primarily of compensation for administrative, executive, and software development staff, fees for professional services, rent, bad debt expense, amortization of intangible assets, and general office expense. General and administrative expenses were \$9.4 million and \$8.4 million for the three months ended March 31, 2012 and March 31, 2011, respectively.

General and administrative expenses increased \$1.0 million for the three months ended March 31, 2012 from the three months ended March 31, 2011. The increase was primarily due to a \$669,000 increase in salary and employee related expenses due primarily to an increase in headcount, and a \$178,000 increase in professional services expense.

Unexchanged Merger Shares

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to a previously-announced unclaimed property review. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo which have not been claimed by former shareholders of Travelzoo.com Corporation following a 2002 merger, as previously disclosed in the company's report on Form 10-K. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as demandable under Delaware escheat laws. While the Company continues to take the position that such shares were issuable only to persons who establish their eligibility as shareholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. Under the terms of the agreement, the Company made a \$20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims. The \$20.0 million payment was recorded as an expense in the three months ended March 31, 2011.

During March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged merger share, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3 million charge related to this unexchanged merger share contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged merger share contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company's shares at the end of March 2012, the cost to the Company would be approximately \$20.0 million in excess of the amount accrued. However, the Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

See Note 1 to the consolidated financial statements for further information on the unexchanged merger share contingency.

Table of Contents**Income Taxes**

Our income is generally taxed in the U.S., Canada and our income tax provisions reflect federal, state and country statutory rates applicable to our levels of income, adjusted to take into account expenses that are treated as having no recognizable tax benefit. Income tax expense was \$2.9 million and \$4.0 million for the three months ended March 31, 2012 and 2011, respectively. Our effective tax rate was 44% and (40)% for the three months ended March 31, 2012 and 2011, respectively.

Our effective tax rate increased for the three months ended March 31, 2012 from the three months ended March 31, 2011 due primarily to the \$20.0 million expense for the settlement with the State of Delaware that was treated as having no recognizable tax benefits in the three months ended March 31, 2011. We expect that our effective tax rate in future periods may fluctuate depending on the total amount of expenses representing payments to former stockholders, losses or gains incurred by our operations in Canada and Europe, the use of accumulated losses to offset current taxable income and need for valuation allowances on certain tax assets, if any.

United States income and foreign withholding taxes have not been provided on undistributed earnings for certain non-U.S. subsidiaries. The undistributed earnings on a book basis for the non-U.S. subsidiaries are approximately \$1.3 million. The Company intends to reinvest these earnings indefinitely in its operations outside the U.S. If the undistributed earnings are remitted to the U.S. these amounts would be taxable in the U.S. at the current federal and state tax rates net of foreign tax credits. Also, depending on the jurisdiction any distribution may be subject to withholding taxes at rates applicable for that jurisdiction.

We file income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. We are subject to U.S. federal and certain state tax examinations for years after 2007 and are subject to California tax examinations for years after 2004. We are under examination by federal and state taxing authorities. We believe that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations, although we cannot assure you that this will be the case given the inherent uncertainties in these examinations. Due to the ongoing tax examinations, we believe it is impractical to determine the amount and timing of these adjustments.

North America

| | Three Months Ended March 31, | |
|---|-------------------------------------|-------------|
| | 2012 | 2011 |
| | (In thousands) | |
| Net revenues | \$ 28,635 | \$ 27,618 |
| Income from operations | 7,142 | 9,252 |
| Income from operations as a % of revenues | 24.9% | 33.5% |

North America net revenues increased \$1.0 million for the three months ended March 31, 2012 from the three months ended March 31, 2011 (see Revenues above). North America expenses increased \$3.1 million for the three months ended March 31, 2012 from the three months ended March 31, 2011. This increase was primarily due to a \$1.4 million increase in cost of revenue primarily related to Local Deals and Getaways credit card fees, customer service and certain subscriber refunds, a \$1.7 million salary and employee related expense due in part to a head count increase, a \$649,000 increase in Search traffic acquisition costs, and a \$179,000 increase in rent, office and insurance expense; offset by \$1.2 million decrease in subscriber acquisition cost.

Europe

| | Three Months Ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| | (In thousands) | |
| Net revenues | \$ 10,787 | \$ 9,448 |
| Income (loss) from operations | 2,428 | 741 |
| Income (loss) from operations as a % of revenues | 22.5% | 7.8% |

Europe net revenues increased \$1.3 million for the three months ended March 31, 2012 from the three months ended March 31, 2011 (see Revenues above). Europe expenses decreased \$348,000 for the three months ended March 31, 2012 from the three months ended March 31, 2011. This decrease was primarily due to a \$1.4 million decrease in subscriber acquisition cost, offset by a \$571,000 increase in salary and employee related expense due in part to a head count increase, a \$317,000 increase in Search traffic acquisition costs and a \$225,000 increase in

Edgar Filing: TRAVELZOO INC - Form 10-Q

cost of revenue primarily related to *Local Deals* and *Getaways* credit card fees, customer service and certain subscriber refunds. Foreign currency movements relative to the U.S. dollar negatively impacted our income from our operations in Europe by approximately \$71,000 for the three months ended March 31, 2012. Foreign currency movements relative to the U.S. dollar positively impacted our income from our operations in Europe by approximately \$75,000 for the three months ended March 31, 2011.

Table of Contents**Liquidity and Capital Resources**

As of March 31, 2012, we had \$48.6 million in cash and cash equivalents. Cash and cash equivalents increased from \$38.7 million as of December 31, 2011 primarily as a result of cash provided by operating and investing activities as explained below. We expect that cash on hand will be sufficient to provide for working capital needs for at least the next 12 months.

| | Three Months Ended March 31, | |
|--|-------------------------------------|------------------|
| | 2012 | 2011 |
| | (In thousands) | |
| Net cash provided by operating activities | \$ 9,787 | \$ 10,662 |
| Net cash used in investing activities | (678) | (699) |
| Net cash provided by financing activities | | 308 |
| Effect of exchange rate changes on cash and cash equivalents | 706 | 243 |
| Net increase in cash and cash equivalents | \$ 9,815 | \$ 10,514 |

Net cash provided by in operating activities is net income adjusted for certain non-cash items and changes in assets and liabilities. Net cash provided by operating activities for the three months ended March 31, 2012 decreased by \$875,000 compared to the three months ended March 31, 2011. The \$875,000 decrease in cash provided by operating activities was due primarily to a \$17.8 million decrease in accrued expenses and a \$3.0 million decrease in accounts payable, offset by a \$17.7 million increase in net income, a \$1.6 million increase in accounts receivable and a \$581,000 increase in income tax receivable. The \$17.7 million increase in net income was primarily due to a \$17.0 million decrease in expenses related to unexchanged merger shares.

Net cash used in investing activities was \$678,000 for the three months ended March 31, 2012 compared to \$699,000 for the three months ended March 31, 2011. The \$21,000 decrease in cash used in investing activities was due primarily to a \$21,000 decrease in purchases of property and equipment.

Net cash provided by financing activities was zero for the three months ended March 31, 2012 compared to net cash provided by financing activities of \$308,000 for the three months ended March 31, 2011. For the three months ended March 31, 2011, net cash provided by financing activities was due to proceeds from the exercise of stock options and the excess tax benefit from exercise of stock options.

On April 21, 2011, the Company entered into an agreement which required a \$20.0 million cash payment to the State of Delaware resolving all claims relating to the State of Delaware's unclaimed property review, which related primarily to unexchanged merger share contingency. During March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged merger share, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3 million charge related to this unexchanged merger share contingency. While the Company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged merger share contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company's shares at the end of March 2012, the cost to the Company would be approximately \$20.0 million in excess of the amount accrued. However, the Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company is not able to predict the amount or outcome of any future claims which might be asserted related to the unissued shares. The Company is continuing its program under which it makes cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. See Note 1 to the accompanying financial statements for further details.

Our capital requirements depend on a number of factors, including market acceptance of our products and services, the amount of our resources we devote to the development of new products, cash payments to former stockholders of Travelzoo.com Corporation, expansion of our operations, and the amount of resources we devote to promoting awareness of the *Travelzoo* and *Fly.com* brands. Since the inception of the program under which we make cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period, we have incurred expenses of \$2.9 million. While future payments for this program are expected to decrease, the total cost of this program is still undeterminable because it is dependent on our stock price and on the number of valid requests ultimately received.

Table of Contents

Consistent with our growth, we have experienced substantial increases in our cost of revenues, sales and marketing expenses and our general and administrative expenses, and we anticipate that these increases will continue for the foreseeable future. We believe cash on hand will be sufficient to pay such costs for at least the next twelve months. In addition, we will continue to evaluate possible investments in businesses, products and technologies, the consummation of any of which would increase our capital requirements.

Although we currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements for at least the next 12 months, unanticipated events and opportunities or a less favorable than expected development of our business in Europe may require us to sell additional equity or debt securities or establish new credit facilities to raise capital in order to meet our capital requirements.

If we sell additional equity or convertible debt securities, the sale could dilute the ownership of our existing stockholders. If we issue debt securities or establish a new credit facility, our fixed obligations could increase, and we may be required to agree to operating covenants that would restrict our operations. We cannot be sure that any such financing will be available in amounts or on terms acceptable to us.

If the development of our business is less favorable than expected, we may decide to significantly reduce the size of our operations and marketing expenses in certain markets with the objective of reducing cash outflow.

The information set forth under Note 5 Commitments and Contingencies to the condensed consolidated financial statements included in Part I, Item 1 of this report is incorporated herein by reference. Litigation against the Company may result in legal defense costs, settlements or judgments that could have a material impact on our financial condition.

The following summarizes our principal contractual commitments as of March 31, 2012 (in thousands):

| | thereafter 2012 | thereafter 2013 | thereafter 2014 | thereafter 2015 | thereafter 2016 | thereafter Thereafter | thereafter Total |
|--------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------------|---------------------|
| Operating leases | \$ 3,268 | \$ 3,298 | \$ 1,622 | \$ 1,493 | \$ 1,137 | \$ 1,534 | \$ 12,352 |
| Purchase obligations | 434 | 389 | 94 | | | | 917 |
| Total commitments | \$ 3,702 | \$ 3,687 | \$ 1,716 | \$ 1,493 | \$ 1,137 | \$ 1,534 | \$ 13,269 |

We also have contingencies related to net unrecognized tax benefits of approximately \$1.9 million as of March 31, 2012. We are unable to make reasonably reliable estimates on the timing of the cash settlements with the respective taxing authorities.

Critical Accounting Policies

We believe that there are a number of accounting policies that are critical to understanding our historical and future performance, as these policies affect the reported amounts of revenue and the more significant areas involving management's judgments and estimates. These significant accounting policies relate to revenue recognition, reserve for subscriber refunds, allowance for doubtful accounts, income tax and loss contingencies. These policies, and our procedures related to these policies, are described in detail below.

Revenue Recognition

We recognize revenue on arrangements in accordance with the SEC Staff Accounting Bulletin for revenue recognition. We recognize advertising revenues in the period in which the advertisement is displayed, provided that evidence of an arrangement exists, the fees are fixed or determinable and collection of the resulting receivable is reasonably assured. Effective January 1, 2011, we adopted ASU 2009-13. The adoption of this new accounting standard had no material impact on the Company's consolidated results of operations. If fixed-fee advertising is displayed over a term greater than one month, revenues are recognized ratably over the period as described below. The majority of insertion orders have terms that begin and end in a quarterly reporting period. In the cases where at the end of a quarterly reporting period the term of an insertion order is not complete, the Company allocates the total arrangement fee to each element based on the relative estimated selling price of each element. The Company uses prices stated on its internal rate card, which represents stand-alone sales prices, to establish estimated selling prices. The stand-alone price is the price that would be charged if the advertiser purchased only the individual insertion. Fees for variable-fee advertising arrangements are recognized based on the number of impressions displayed, number of clicks delivered, or number of referrals generated during the period. Under these policies, no revenue is recognized unless persuasive evidence of an arrangement exists, delivery has

Edgar Filing: TRAVELZOO INC - Form 10-Q

occurred, the fee is fixed or determinable, and collection is deemed reasonably assured. The Company evaluates each of these criteria as follows:

Evidence of an arrangement. We consider an insertion order signed by the advertiser or its agency to be evidence of an arrangement.

Delivery. Delivery is considered to occur when the advertising has been displayed and, if applicable, the click-throughs have been delivered.

Table of Contents

Fixed or determinable fee. We consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment and payment terms are standard.

Collection is deemed reasonably assured. We conduct a credit review for all transactions at the time of the arrangement to determine the creditworthiness of the advertiser. Collection is deemed reasonably assured if we expect that the advertiser will be able to pay amounts under the arrangement as payments become due. If we determine that collection is not reasonably assured, then we defer the revenue and recognize the revenue upon cash collection. Collection is deemed not reasonably assured when an advertiser is perceived to be in financial distress, which may be evidenced by weak industry conditions, a bankruptcy filing, or previously billed amounts that are past due.

Revenues from advertising sold to advertisers through agencies are reported at the net amount billed to the agency.

During the third quarter of 2010, the Company started selling vouchers for *Local Deals* and *Getaways* from local businesses such as spas, hotels and restaurants. The Company earns a fee for acting as an agent in these transactions which is recorded on a net basis and is included in revenue upon completion of the voucher sale. Certain merchant contracts in foreign locations allow us to retain fees related to vouchers sold that are not redeemed by purchasers upon expiration, which we recognize as revenue after the expiration of the redemption period and after there are no further obligations to provide funds to merchants, subscribers or others.

Reserve for Subscriber Refunds

We record an estimated reserve for subscriber refunds based on our historical experience at the time revenue is recorded for *Local Deals* and *Getaways* voucher sales. We accrue costs associated with refunds in accrued expenses on the consolidated balance sheets. We consider many key factors such as the historical refunds based upon the time lag since the sale, historical reasons for refunds, time period that remains until the deal expiration date, any changes in refund procedures and estimates of redemptions and breakage. Should any of these factors change, the estimates made by management will also change, which could impact the level of our future reserves for subscriber refunds. Specifically, if the financial condition of our advertisers, the business that is providing the vouchered service, were to deteriorate, affecting their ability to provide the services to our subscribers, additional reserves for subscriber refunds may be required.

Estimated subscriber refunds that are determined to be recoverable from the merchant are recorded in the consolidated statements of operations as a reduction to revenue. Estimated subscriber refunds that are determined not to be recoverable from the merchant, are presented as a cost of revenue. If our judgments regarding estimated subscriber refunds are inaccurate, reported results of operations could differ from the amount we previously accrued.

Allowance for Doubtful Accounts

We record a provision for doubtful accounts based on our historical experience of write-offs and a detailed assessment of our accounts receivable and allowance for doubtful accounts. In estimating the provision for doubtful accounts, management considers the age of the accounts receivable, our historical write-offs, the creditworthiness of the advertiser, the economic conditions of the advertiser's industry, and general economic conditions, among other factors. Should any of these factors change, the estimates made by management will also change, which could impact the level of our future provision for doubtful accounts. Specifically, if the financial condition of our advertisers were to deteriorate, affecting their ability to make payments, additional provision for doubtful accounts may be required.

Income Taxes

We are subject to income taxes in the U.S. and numerous foreign jurisdictions. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related net interest.

Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, state taxes, certain benefits realized related to stock option activities, research and experimentation tax credits, the extent that our earnings are indefinitely reinvested outside the U.S. and tax asset valuation allowance determinations including on certain loss carryforwards. For the three months ended March 31, 2012 and 2011, our effective tax rates were 44% and (40)%, respectively. Our future effective tax rates could be adversely affected by earnings being

Edgar Filing: TRAVELZOO INC - Form 10-Q

lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, changes in the deferred tax assets or liabilities, changes in tax asset valuation allowance determinations including on certain loss carryforwards, changes in our judgment about whether certain foreign earnings are indefinitely reinvested outside the U.S., or changes in tax laws, regulations, and accounting principles. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

Table of Contents

Loss Contingencies

We are involved in claims, suits, and proceedings arising from the ordinary course of our business. We record a provision for a liability when we believe that it is both probable that a liability has been incurred, and the amount can be reasonably estimated. Significant judgment is required to determine both probability and the estimated amount. Such claim proceedings are inherently unpredictable and subject to significant uncertainties, some of which are beyond our control. Should any of these estimates and assumptions change or prove to have been incorrect, it could have a material impact on our results of operations, financial position and cash flows. We have several known loss contingencies such as our liability to former stockholders of Travelzoo.com Corporation that may be realized as a result of our cash program for these claimants, State unclaimed property claims or otherwise and several lawsuits, both class actions and derivative suits. Please refer to Note 5 to the consolidated financial statements for further details about our loss contingencies.

RISK FACTORS

Investing in our common stock involves a high degree of risk. Any or all of the risks listed below as well as other variables affecting our operating results could have a material adverse effect on our business, our quarterly and annual operating results or financial condition, which could cause the market price of our stock to decline or cause substantial volatility in our stock price, in which event the value of your common stock could decline. You should also keep these risk factors in mind when you read forward-looking statements.

Risks Related to Our Financial Condition and Business Model

We cannot assure you that we will be profitable.

For the three months ended March 31, 2012, we generated a net income of \$3.7 million. For the three months ended March 31, 2011, we incurred a net loss of \$14.0 million. In the year ended December 31, 2010 and 2011, we generated a net income of \$13.2 million and \$3.3 million. Although we were profitable in 2011 and 2010, there is no assurance that we will continue to be profitable in the future. We forecast our future expense levels based on our operating plans and our estimates of future revenues. We may find it necessary to significantly accelerate expenditures relating to our sales and marketing efforts or otherwise increase our financial commitment to creating and maintaining brand awareness among Internet users and advertisers. If our revenues grow at a slower rate than we anticipate, or if our spending levels exceed our expectations or cannot be adjusted to reflect slower revenue growth, we may not generate sufficient revenues to be profitable. Any of these developments could result in a significant decrease in the trading price of our common stock.

Fluctuations in our operating results may negatively impact our stock price.

Our quarterly and annual operating results may fluctuate significantly in the future due to a variety of factors that could affect our revenues or our expenses in any particular period. You should not rely on quarter-to-quarter comparisons of our results of operations as an indication of future performance. Factors that may affect our quarterly results include:

mismatches between resource allocation and client demand due to difficulties in predicting client demand in a new market;

changes in general economic conditions that could affect marketing efforts generally and online marketing efforts in particular;

the magnitude and timing of marketing initiatives, including our acquisition of new subscribers and our expansion efforts in other regions;

the introduction, development, timing, competitive pricing and market acceptance of our products and services and those of our competitors;

our ability to attract and retain key personnel;

Edgar Filing: TRAVELZOO INC - Form 10-Q

our ability to manage our anticipated growth and expansion;

our ability to attract traffic to our websites;

technical difficulties or system downtime affecting the Internet generally or the operation of our products and services specifically;

payments which we may make to previous stockholders of Travelzoo.com Corporation who failed to submit requests for shares in Travelzoo Inc. within the required time period, or escheat claims related to shares not issued in the Company's merger with Travelzoo.com Corporation; and

volatility of our operating results in new markets.

Table of Contents

We may significantly increase our operating expenses related to advertising campaigns for the *Travelzoo* and *Fly.com* brands for a certain period if we see a unique opportunity for a brand marketing campaign, if we find it necessary to respond to increased brand marketing by a competitor, or if we decide to accelerate our acquisition of new subscribers.

If revenues fall below our expectations in any quarter and we are unable to quickly reduce our operating expenses in response, our operating results would be lower than expected and our stock price may fall.

Our expansion of our product offering to include Local Deals format may result in additional costs that exceed revenue and may trigger additional stock volatility.

During the third quarter of 2010, we launched our Local Deals format of advertising, under which we sell vouchers directly to consumers to advertise promotional deals provided by merchants. For example, a consumer could buy a voucher for \$99 for a dinner for two at a merchant's restaurant that would normally be valued at \$199, representing a promotional value of \$100 to the consumer. This format involves several aspects that are new to us, and will require investments to maintain and grow the business including additional sales force hiring, building a customer service organization, marketing, technology tracking systems and payment processing. This format, introduced to the market in recent years, has resulted in many competitors entering the marketplace, thereby creating a very competitive marketplace. This competitive landscape along with the required investments to start, maintain and grow this format create a risk that our costs may exceed our revenues in the short and long term, which may materially impact our results of operation and financial condition. Operating this format may introduce additional volatility to our stock price due to the performance of this format by the Company and/or the overall market valuations that are being determined by the market for companies operating this format of advertising.

Our business model may not be adaptable to a changing market.

Our current revenue model depends on advertising fees paid primarily by travel and entertainment companies. If current clients decide not to continue advertising their offers with us and we are unable to replace them with new clients, our business may be adversely affected. To be successful, we must provide online marketing solutions that achieve broad market acceptance by travel and entertainment companies. In addition, we must attract sufficient Internet users with attractive demographic characteristics to our products. It is possible that we will be required to further adapt our business model in response to changes in the online advertising market or if our current business model is not successful. If we are not able to anticipate changes in the online advertising market or if our business model is not successful, our business could be materially adversely affected.

If we fail to retain existing advertisers or add new advertisers, our revenue and business will be harmed.

We depend on our ability to attract and retain advertisers (hotels, spas, restaurants, vacation packagers, airlines, etc.) that are prepared to offer products or services on compelling terms to our subscribers. We do not have long-term arrangements to guarantee the availability of deals that offer attractive quality, value and variety to consumers or favorable payment terms to us. We must continue to attract and retain advertisers in order to increase revenue and maintain profitability. If new advertisers do not find our marketing and promotional services effective, or if existing advertisers do not believe that utilizing our products provides them with a long-term increase in customers, revenue or profit, they may stop making offers through our marketplace. In addition, we may experience attrition in our advertisers in the ordinary course of business resulting from several factors, including losses to competitors and advertiser closures or bankruptcies. If we are unable to attract new advertisers in numbers sufficient to grow our business, or if too many advertisers are unwilling to offer products or services with compelling terms to our subscribers or offer favorable payment terms to us, we may sell less advertising, and our operating results will be adversely affected.

Our existing advertisers may shift from one advertising service to another, which may adversely affect our revenue.

Existing advertisers may shift from one advertising service (e.g. *Top 20*) to another (e.g. *Local Deals* and *Getaways*). These shifts between advertising services by advertisers could result in no incremental revenue or less revenue than in previous periods depending on the amount purchased by the advertisers, and in particular with *Local Deals* and *Getaways*, depending on how many vouchers are purchased by subscribers.

An increase in our refund rates related to our Local Deals and Getaways could reduce our liquidity and profitability.

We provide refunds related to our *Local Deals* and *Getaways* voucher sales. As we increase our revenue, our refund rates may exceed our historical levels. A downturn in general economic conditions may also increase our refund rates. An increase in our refund rates could significantly reduce our liquidity and profitability.

Edgar Filing: TRAVELZOO INC - Form 10-Q

As we do not have control over our merchants and the quality of products or services they deliver, we rely on a combination of our historical experience with our merchants over time and the type of refunds provided for development of our estimate for refund claims. Our actual level of refund claims could prove to be greater than the level of refund claims we estimate. If our refund reserves are not adequate to cover future refund claims, this inadequacy could have a material adverse effect on our liquidity and profitability.

Table of Contents

Our standard agreements with our merchants generally limit the time period during which we may seek reimbursement for subscriber refunds or claims. Our subscribers may make claims for refunds with respect to which we are unable to seek reimbursement from our merchants. Our inability to seek reimbursement from our merchants for refund claims could have an adverse effect on our liquidity and profitability.

If our advertisers do not meet the needs and expectations of our subscribers, our business could suffer.

Our business depends on our reputation for providing high-quality deals, and our brand and reputation may be harmed by actions taken by advertisers that are outside our control. In particular, this is the case with our *Local Deals* and *Getaways* merchants, since we are selling vouchers, on behalf of the merchants, directly to our subscribers as opposed to the remainder of our business in which we are only collecting the advertising fee from the advertiser and the subscribers are booking the deal directly with the advertiser. Any shortcomings of one or more of our merchants, particularly with respect to an issue affecting the quality of the deal offered or the products or services sold, may be attributed by our subscribers to us, thus damaging our reputation, brand value and potentially affecting our results of operations. In addition, negative publicity and subscriber sentiment generated as a result of fraudulent or deceptive conduct by our merchants could damage our reputation, reduce our ability to attract new subscribers or retain our current subscribers, and diminish the value of our brand.

Our business relies heavily on email and other messaging services, and any restrictions on the sending of emails or messages or a decrease in subscriber willingness to receive messages could adversely affect our revenue and business.

Our business is highly dependent upon email and other messaging services. Deals offered through emails and other messages sent by us, or on our behalf by our affiliates, generate a substantial portion of our revenue. Because of the importance of email and other messaging services to our businesses, if we are unable to successfully deliver emails or messages to our subscribers or potential subscribers, or if subscribers decline to open our emails or messages, our revenue and profitability would be adversely affected. Actions by third parties to block, impose restrictions on, or charge for the delivery of, emails or other messages could also materially and adversely impact our business. From time to time, internet service providers block bulk email transmissions or otherwise experience technical difficulties that result in our inability to successfully deliver emails or other messages to third parties. In addition, our use of email and other messaging services to send communications about our website or other matters may result in legal claims against us, which if successful might limit or prohibit our ability to send emails or other messages. Any disruption or restriction on the distribution of emails or other messages or any increase in the associated costs would materially and adversely affect our revenue and profitability.

Our total number of subscribers may be higher than the number of our actual individual subscribers and may not be representative of the number of persons who are active potential customers.

Our total number of subscribers may be higher than the number of our actual individual subscribers because some subscribers have multiple registrations, other subscribers have died or become incapacitated and others may have registered under fictitious names. Given the challenges inherent in identifying these subscribers, we do not have a reliable system to accurately identify the number of actual individual subscribers, and thus we rely on the number of total subscribers as our measure of the size of our subscriber base. In addition, the number of subscribers includes the total number of individuals that have completed registration through a specific date, less individuals who have unsubscribed. The number of subscribers may include individuals who do not receive our emails because our emails have been blocked or are otherwise undeliverable. As a result, the number of subscribers should not be considered as representative of the number of persons who continue to actively consider our deals by reviewing our email offers.

We may not be able to obtain sufficient funds to grow our business and any additional financing may be on terms adverse to your interests.

During the three months ended March 31, 2012, our cash and cash equivalents increased by \$9.8 million to \$48.6 million. We intend to continue to grow our business and fund our current operations using cash on hand. However, this may not be sufficient to meet our needs. We may not be able to obtain financing on commercially reasonable terms, or at all.

If additional financing is not available when required or is not available on acceptable terms, we may be unable to fund our expansion, successfully promote our brand name, develop or enhance our products and services, take advantage of business opportunities, or respond to competitive pressures, any of which could have a material adverse effect on our business.

If we choose to raise additional funds through the issuance of equity securities, you may experience significant dilution of your ownership interest and holders of the additional equity securities may have rights senior to those of the holders of our common stock. If we obtain additional financing by issuing debt securities or bank borrowings, the terms of these arrangements could restrict or prevent us from paying dividends and could limit our flexibility in making business decisions.

Table of Contents

Our business may be sensitive to recessions.

The demand for online advertising may be linked to the level of economic activity and employment in the U.S. and abroad. Specifically, our business is primarily dependent on the demand for online advertising from travel and entertainment companies. The recent recession decreased consumer travel and caused travel and entertainment companies to reduce or postpone their marketing spending generally, and their online marketing spending in particular. Continued or future recessions could have a material adverse effect on our business and financial condition.

Our operations could be significantly hindered by the occurrence of a natural disaster or other catastrophic event.

Our operations are susceptible to outages due to fire, floods, power loss, telecommunications failures, unexpected technical problems in the systems that power our websites and distribute our e-mail newsletters, break-ins and similar events. In addition, a significant portion of our network infrastructure is located in Northern California, an area susceptible to earthquakes. We do not have multiple site capacity to protect us against any such occurrence. Outages could cause significant interruptions of our service. In addition, despite our implementation of network security measures, our servers are vulnerable to computer viruses, physical and electronic break-ins, and similar disruptions from unauthorized tampering with our computer systems. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events.

Technological or other assaults on our service could harm our business.

We are vulnerable to coordinated attempts to overload our systems with data, which could result in denial or reduction of service to some or all of our users for a period of time. We have experienced denial of service attacks in the past, and may experience such attempts in the future. Any such event could reduce our revenue and harm our operating results and financial condition. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events.

We are subject to payments-related risks.

We accept payments for the sale of vouchers using a variety of methods, including credit cards and debit cards. We pay interchange and other fees, which may increase over time and raise our operating expenses and lower profitability. We rely on third parties to provide payment processing services, including the processing of credit cards and debit cards, and it could disrupt our business if these companies become unwilling or unable to provide these services to us. We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, which could change or be reinterpreted to make it difficult or impossible for us to comply. Moreover, under payment card rules and our contracts with our card processors, if there is a security breach of payment card information that we store, we could be liable to the payment card issuing banks for their cost of issuing new cards and related expenses. If we fail to comply with these rules or requirements, we may be subject to fines and higher transaction fees and lose our ability to accept credit and debit card payments, process electronic funds transfers, or facilitate other types of online payments, and our business and results of operations could be adversely affected. If one or more of these contracts are terminated and we are unable to replace them on similar terms, or at all, it could adversely affect our results of operations.

Risks Related to Our Markets and Strategy

Our international expansion may result in operating losses, and is subject to other material risks.

In May 2005, we began operations in the U.K. In 2006, we began operations in Canada, Germany, and Spain. In 2007, we began operations in France.

Although our revenues in Europe increased 14% in the three months ended March 31, 2012 from the same period last year and our operations in Europe generated a profit of \$2.4 million for the three months ending March 31, 2012 and a profit of \$4.9 million during the 2011 fiscal year, our operations in Europe incurred a loss of \$1.8 million during the 2010 fiscal year, primarily as a result of significant expenses related to subscriber acquisition and the launch of *Fly.com*. We intend to continue adding a significant number of subscribers in selected countries in which we operate as we believe this is one of the factors that will allow us to increase our advertising rates and increase our revenues in Europe.

Table of Contents

If we incur losses from our operations in Europe in the future, these losses may not have any recognizable tax benefit. We expect that this would have a material negative impact on our net income and cash flows. Any of these developments could result in a significant decrease in the trading price of our common stock. In addition to uncertainty about our ability to generate net income from our foreign operations and expand our international market position, there are certain risks inherent in doing business internationally, including:

trade barriers and changes in trade regulations;

difficulties in developing, staffing and simultaneously managing foreign operations as a result of distance, language and cultural differences;

stringent local labor laws and regulations;

currency exchange rate fluctuations;

risks related to government regulation; and

potentially adverse tax consequences.

If current economic conditions in Europe do not improve or deteriorate further due to the adverse effects of the ongoing sovereign debt crisis, advertisers may delay or reduce advertising or marketing spending. This could result in reductions in sales of our services, longer sales cycles, and increased price competition.

We may not be able to continue developing awareness of our brand names.

We believe that continuing to build awareness of the *Travelzoo* and *Fly.com* brand names is critical to achieving widespread acceptance of our business. Brand recognition is a key differentiating factor among providers of online advertising opportunities, and we believe it could become more important as competition in our industry increases. In order to maintain and build brand awareness, we must succeed in our marketing efforts. If we fail to successfully promote and maintain our brands, incur significant expenses in promoting our brands and fail to generate a corresponding increase in revenue as a result of our branding efforts, or encounter legal obstacles which prevent our continued use of our brand names, our business could be materially adversely affected.

If we fail to retain our existing subscribers or acquire new subscribers, our revenue and business will be harmed.

We spent \$960,000 and \$3.5 million on online marketing initiatives relating to subscriber acquisition for the three months ended March 31, 2012 and 2011 and expect to continue to spend significant amounts to acquire additional subscribers. We must continue to retain and acquire subscribers in order to maintain or increase revenue. We cannot assure you that the revenue from subscribers we acquire will ultimately exceed the cost of acquiring new subscribers. If subscribers do not perceive our offers to be of high value and quality or if we fail to introduce new and more relevant deals, we may not be able to acquire or retain subscribers. If we reduce our subscriber acquisition costs we cannot assure you that this will not adversely impact our ability to acquire new subscribers. If we are unable to acquire new subscribers who purchase our deals directly or indirectly in numbers sufficient to grow our business, or if subscribers cease to purchase our deals directly or indirectly through our advertisers, the revenue we generate may decrease and our operating results will be adversely affected. If the level of usage by our subscriber base declines or does not grow as expected, we may suffer a decline in subscriber growth or revenue. A significant decrease in the level of usage or subscriber growth would have an adverse effect on our business, financial condition and results of operations.

Our business may be sensitive to events affecting the travel industry in general.

Events like the war with Iraq or the terrorist attacks on the U.S. in 2001 or the recent global financial crisis have a negative impact on the travel industry. We are not in a position to evaluate the net effect of these circumstances on our business. In the longer term, our business might be

Edgar Filing: TRAVELZOO INC - Form 10-Q

negatively affected by financial pressures on the travel industry. However, our business may also benefit if travel companies increase their efforts to promote special offers or other marketing programs. If such events result in a long-term negative impact on the travel industry, such impact could have a material adverse effect on our business.

We may not be able to attract travel and entertainment companies or Internet users if we do not continually enhance and develop the content and features of our products and services.

To remain competitive, we must continually improve the responsiveness, functionality, and features of our products and services. We may not succeed in developing features, functions, products, or services that travel and entertainment companies and Internet users find attractive. This could reduce the number of travel and entertainment companies and Internet users using our products and materially adversely affect our business.

Table of Contents

We may lose business if we fail to keep pace with rapidly changing technologies and client needs.

Our success is dependent on our ability to develop new and enhanced software, services, and related products to meet rapidly evolving technological requirements for online advertising. Our current technology may not meet the future technical requirements of travel and entertainment companies. Trends that could have a critical impact on our success include:

rapidly changing technology in online advertising;

evolving industry standards, including both formal and *de facto* standards relating to online advertising;

developments and changes relating to the Internet;

competing products and services that offer increased functionality; and

changes in travel company, entertainment company, and Internet user requirements.

If we are unable to timely and successfully develop and introduce new products and enhancements to existing products in response to our industry's changing technological requirements, our business could be materially adversely affected.

Our business and growth will suffer if we are unable to hire and retain highly skilled personnel.

Our future success depends on our ability to attract, train, motivate, and retain highly skilled employees. We may be unable to retain our skilled employees, or attract, assimilate, and retain other highly skilled employees in the future. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. If we are unable to hire and retain skilled personnel, our growth may be restricted, which could adversely affect our future success.

We may not be able to effectively manage our expanding operations.

Since the commencement of our operations, we have experienced a period of rapid growth. In order to execute our business plan, we must continue to grow significantly. As of March 31, 2012, we had 360 employees, up from 296 employees as of March 31, 2011. We expect that the number of our employees will continue to increase for the foreseeable future. This growth has placed, and our anticipated future growth will continue to place, a significant strain on our management, systems, and resources. We expect that we will need to continue to improve our financial and managerial controls and reporting systems and procedures. We will also need to continue to expand and maintain close coordination among our sales, production, marketing, IT, and finance departments. We may not succeed in these efforts. Our inability to expand our operations in an efficient manner could cause our expenses to grow disproportionately to revenues, our revenues to decline or grow more slowly than expected and could otherwise have a material adverse effect on our business.

Intense competition may adversely affect our ability to achieve or maintain market share and operate profitably.

We compete for advertising dollars with large Internet portal sites, such as MSN and Yahoo! that offer listings or other advertising opportunities to travel, entertainment and local companies. These companies have significantly greater financial, technical, marketing and other resources and larger advertiser bases. We compete with search engines like Google and Bing that offer pay-per-click listings. We compete with travel meta-search engines like Kayak and online travel and entertainment deal publishers. We compete with large online travel agencies like Expedia and Priceline that also offer advertising placements and capture consumer interest. We compete with companies like Groupon and LivingSocial that sell vouchers for deals from local businesses such as spas, hotels and restaurants. We expect to face increased competition from other internet and technology-based businesses such as Google and Microsoft, each of which has launched initiatives which are directly competitive to our *Local Deals* and *Getaways* products. We also have seen that some competitors will accept lower margins, or negative margins, to attract attention and acquire new subscribers. If competitors engage in group buying initiatives in which merchants receive a higher percentage of the face value than we currently offer, we may be forced to pay a higher percentage of the face value than we currently offer, which may reduce our

Edgar Filing: TRAVELZOO INC - Form 10-Q

revenue. In addition, we compete with newspapers, magazines and other traditional media companies that operate websites which provide online advertising opportunities. We expect to face additional competition as other established and emerging companies, including print media companies, enter the online advertising market. Competition could result in reduced margins on our services, loss of market share or less use of *Travelzoo* by advertisers and consumers. If we are not able to compete effectively with current or future competitors as a result of these and other factors, our business could be materially adversely affected.

Loss of any of our key management personnel could negatively impact our business.

Our future success depends to a significant extent on the continued service and coordination of our management team, particularly Christopher Loughlin, our Chief Executive Officer. The loss or departure of any of our officers or key employees could materially adversely affect our ability to implement our business plan. We do not maintain key person life insurance for any member of our management team. In addition, we expect new members to join our management team in the future. These individuals will not previously have worked together and will be required to become integrated into our management team. If our key management personnel are not able to work together effectively or successfully, our business could be materially adversely affected.

Table of Contents

We may not be able to access third party technology upon which we depend.

We use technology and software products from third parties including Microsoft and ITA Software. Technology from our current or other vendors may not continue to be available to us on commercially reasonable terms, or at all. Our business will suffer if we are unable to access this technology, to gain access to additional products or to integrate new technology with our existing systems. This could cause delays in our development and introduction of new services and related products or enhancements of existing products until equivalent or replacement technology can be accessed, if available, or developed internally, if feasible. If we experience these delays, our business could be materially adversely affected.

Risks Related to the Market for our Shares

Our stock price has been volatile historically and may continue to be volatile.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. During the twelve months ended April 25, 2012, the closing price of our common stock on the NASDAQ Global Select Market ranged from \$21.02 to \$87.79. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results; announcements of technological innovations or new products by us or our competitors; changes in financial estimates and recommendations by securities analysts; the operating and stock price performance of other companies that investors may deem comparable to us; and news reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and the market prices for Internet-related companies in particular, have experienced volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our stock, regardless of our operating performance.

We are controlled by a principal stockholder.

Ralph Bartel, who founded Travelzoo and who is a Director of Travelzoo, is our largest stockholder, holding beneficially, as of April 27, 2012, approximately 53.3% of our outstanding shares. Through his share ownership, he is in a position to control Travelzoo and to elect our entire board of directors.

Risks Related to Legal Uncertainty

We may become subject to shareholder lawsuits over securities violations due to volatile stock price and this can be burdensome to management and costly to defend.

Shareholder lawsuits for securities violations are often launched against companies whose stock price is volatile. Such lawsuits involving the Company would require management's attention to defend, which may distract attention from operating the Company. In addition, the Company may incur substantial costs to defend itself and/or settle such claims, which may be considered advisable to minimize the distraction and costs of defense. Such lawsuits would result in judgments against the Company requiring substantial payments to claimants. Such costs may materially impact our results of operations and financial condition. During the third quarter ended September 30, 2011, numerous class action and derivative lawsuits were filed against the Company. See further disclosure in Note 5 to the Condensed Consolidated Financial Statements included in this report.

We may become subject to burdensome government regulations and legal uncertainties affecting the Internet which could adversely affect our business.

To date, governmental regulations have not materially restricted use of the Internet in our markets. However, the legal and regulatory environment that pertains to the Internet is uncertain and may change. Uncertainty and new regulations could increase our costs of doing business, prevent us from delivering our products and services over the Internet, or slow the growth of the Internet. In addition to new laws and regulations being adopted, existing laws may be applied to the Internet. New and existing laws may cover issues which include:

user privacy;

anti-spam legislation;

consumer protection;

copyright, trademark and patent infringement;

pricing controls;

characteristics and quality of products and services;

Table of Contents

sales and other taxes; and

other claims based on the nature and content of Internet materials.

We may be liable as a result of information retrieved from or transmitted over the Internet.

We may be sued for defamation, negligence, copyright or trademark infringement or other legal claims relating to information that is published or made available in our products. These types of claims have been brought, sometimes successfully, against online services in the past. The fact that we distribute information via e-mail may subject us to potential risks, such as liabilities or claims resulting from unsolicited e-mail or spamming, lost or misdirected messages, security breaches, illegal or fraudulent use of e-mail or interruptions or delays in e-mail service. In addition, we could incur significant costs in investigating and defending such claims, even if we ultimately are not liable. If any of these events occur, our business could be materially adversely affected.

The implementation of the CARD Act and similar state and foreign laws may harm our Local Deals business.

Vouchers which are issued under our Local Deals may be considered gift cards, gift certificates, stored value cards or prepaid cards and therefore governed by, among other laws, the CARD Act, and state laws governing gift cards, stored value cards and coupons. Other foreign jurisdictions have similar laws in place, in particular European jurisdictions where the European E-Money Directive regulates the business of electronic money institutions. Many of these laws contain provisions governing the use of gift cards, gift certificates, stored value cards or prepaid cards, including specific disclosure requirements and prohibitions or limitations on the use of expiration dates and the imposition of certain fees. For example, if the vouchers are subject to the CARD Act and are not included in the exemption for promotional programs, it is possible that the purchase value, which is the amount equal to the price paid for the voucher, or the promotional value, which is the add-on value of the voucher in excess of the price paid, or both, may not expire before the later of (i) five years after the date on which the voucher was issued; (ii) the voucher's stated expiration date (if any); or (iii) a later date provided by applicable state law. Purported class actions against other companies have been filed in federal and state court claiming that coupons similar to the vouchers are subject to the CARD Act and various state laws governing gift cards and that the defendants have violated these laws by issuing the coupons with expiration dates and other restrictions. In addition, investigations by certain state attorney general offices have been launched against other companies with regards to similar issues. If similar claims are asserted against the Company in respect of the Local Deals vouchers and are successful, we may become subject to fines and penalties and incur additional costs. In addition, if federal or state laws require that the face value of our vouchers have a minimum expiration period beyond the period desired by a merchant for its promotional program, or no expiration period, this may affect the willingness of merchants to issue vouchers in jurisdictions where these laws apply. Such developments may materially and adversely affect the profitability or viability of our *Local Deals* and *Getaways*.

If we are required to materially increase the estimated liability recorded in our financial statements with respect to unredeemed Local Deals and Getaways vouchers due to application of certain gift card laws, our net income could be materially and adversely affected.

In certain states and foreign jurisdictions, our *Local Deals* and *Getaways* vouchers may be considered a gift card. Some of these states and foreign jurisdictions include gift cards under their unclaimed and abandoned property laws which require companies to remit to the government the value of the unredeemed balance on the gift cards after a specified period of time (generally between one and five years) and impose certain reporting and recordkeeping obligations. We do not remit any amounts relating to unredeemed vouchers we sell based on our assessment of applicable laws. The analysis of the potential application of the unclaimed and abandoned property laws to our vouchers is complex, involving an analysis of constitutional and statutory provisions and factual issues, including our relationship with subscribers and merchants and our role as it relates to the issuance and delivery of a voucher. In the event that one or more states or foreign jurisdictions successfully challenges our position on the application of its unclaimed and abandoned property laws to vouchers, or if the estimates that we use in projecting the likelihood of vouchers being redeemed prove to be inaccurate, our liabilities with respect to unredeemed vouchers may be materially higher than the amounts shown in our financial statements. If we are required to materially increase the estimated liability recorded in our financial statements with respect to unredeemed gift cards, our net income could be materially and adversely affected. Moreover, a successful challenge to our position could subject us to penalties or interest on unreported and unremitted sums, and any such penalties or interest would have a further material adverse impact on our net income.

New tax treatment of companies engaged in internet commerce may adversely affect the commercial use of our services and our financial results.

Due to the global nature of the internet, it is possible that various states or foreign countries might attempt to regulate our transmissions or levy sales, income or other taxes relating to our activities. Tax authorities at the international, federal, state and local levels are currently reviewing the appropriate treatment of companies engaged in internet commerce. New or revised international, federal, state or local tax regulations may

Edgar Filing: TRAVELZOO INC - Form 10-Q

subject us or our subscribers to additional sales, income and other taxes. We cannot predict the effect of current attempts to impose sales, income or other taxes on commerce over the internet. New or revised taxes and, in particular, sales taxes, VAT and similar taxes would likely increase the cost of doing business online and decrease the attractiveness of

Table of Contents

advertising and selling goods and services over the internet. New taxes could also create significant increases in internal costs necessary to capture data, and collect and remit taxes. Any of these events could have an adverse effect on our business and results of operations.

We may suffer liability as a result of information retrieved from or transmitted over the internet and claims related to our service offerings.

We may be sued for defamation, civil rights infringement, negligence, patent, copyright or trademark infringement, invasion of privacy, personal injury, product liability, breach of contract, unfair competition, discrimination, antitrust or other legal claims relating to information that is published or made available on our websites or service offerings we make available (including provision of an application programming interface platform for third parties to access our website, mobile device services and geolocation applications). This risk is enhanced in certain jurisdictions outside the United States, where our liability for such third-party actions may be less clear and we may be less protected. In addition, we could incur significant costs in investigating and defending such claims, even if we ultimately are not found liable. If any of these events occurs, our net income could be materially and adversely affected.

We are subject to risks associated with information disseminated through our websites and applications, including consumer data, content that is produced by our editorial staff and errors or omissions related to our product offerings. Such information, whether accurate or inaccurate, may result in our being sued by our advertisers, merchants, subscribers or third parties and as a result our revenue and goodwill could be materially and adversely affected.

Claims have been asserted against us relating to shares not issued in our 2002 merger.

The merger of Travelzoo.com Corporation into the Company became effective on April 25, 2002. Stockholders of Travelzoo.com Corporation were allowed a period of two years following the effective date to receive shares in the Company. After April 25, 2004, two years following the effective date, we ceased issuing shares to the former stockholders of Travelzoo.com Corporation. Many of the Netsurfer stockholders, who had applied to receive shares of Travelzoo.com Corporation in 1998 for no cash consideration, did not elect to receive their shares which were issuable in the merger prior to the end of the two-year period. A total of 4,115,532 of our shares which had been reserved for issuance in the merger were not claimed.

As discussed above under Note 1, on April 21, 2011, we settled all claims by the State of Delaware relating to a previously-announced unclaimed property review relating to shares of Travelzoo which have not been claimed by former shareholders of Travelzoo.com Corporation. Unclaimed shares which were properly issuable would have been subject to escheat to the State of Delaware because the Company is organized under Delaware law. Under applicable law, unclaimed property held by a corporation is subject to escheat to the jurisdiction of incorporation if the address of the owner is unknown.

During March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged merger share, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3 million charge related to this unexchanged merger share contingency. While the company believes it has meritorious defenses regarding the applicability of escheat rights related to this unexchanged merger share contingency, the ultimate resolution of this matter may take longer than one year to resolve. If the claims for all of the additional shares referred to in the preliminary findings were upheld in full, based on the closing price of the Company's shares at the end of March 2012, the cost to the Company would be approximately \$20.0 million in excess of the amount accrued. However, the Company is not able to predict the ultimate amount or outcome of any current or future claims which have been or might be asserted relating to the unissued shares.

The Company is continuing its program under which it makes cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$11,000 for these cash payments for the three months ended March 31, 2012. The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

Table of Contents

Federal laws and regulations, such as the Bank Secrecy Act and the USA PATRIOT Act and similar foreign laws, could be expanded to include Local Deals and Getaway vouchers.

Various federal laws, such as the Bank Secrecy Act and the USA PATRIOT Act and foreign laws and regulations, such as the European Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, impose certain anti-money laundering requirements on companies that are financial institutions or that provide financial products and services. For these purposes, financial institutions are broadly defined to include money services businesses such as money transmitters, check cashers and sellers or issuers of stored value cards. Examples of anti-money laundering requirements imposed on financial institutions include subscriber identification and verification programs, record retention policies and procedures and transaction reporting. We do not believe that we are a financial institution subject to these laws and regulations based, in part, upon the characteristics of vouchers and our role with respect to the distribution of vouchers to subscribers. However, the Financial Crimes Enforcement Network, a division of the U.S. Department of the Treasury tasked with implementing the requirements of the Bank Secrecy Act, recently issued final rules regarding the scope and requirements for non-bank parties involved in stored value or prepaid access cards, including obligations on sellers or providers of prepaid access. Under the final rule, closed loop vouchers, such as those offered through the Local Deals program, would only be subject to registration if they exceed \$2,000 in total value in any one day or if they are sold in aggregate amounts exceeding \$10,000 to any single person in one day. Should the \$2,000 limit be exceeded or should more than \$10,000 in aggregate vouchers be sold to any individual person (sales to businesses for resale or distribution are excluded) then we may be deemed either a seller or provider of prepaid access subject to regulation. In the event that we become subject to the requirements of the Bank Secrecy Act or any other anti-money laundering law or regulation imposing obligations on us as a money services business, our regulatory compliance costs to meet these obligations would likely increase which could reduce our net income. In addition, the costs for third parties to sell vouchers would increase, which may restrict our ability to enlist third parties to issue vouchers.

Our internal controls over financial reporting may not be effective, and our independent auditors may not be able to certify as to the effectiveness of such internal controls, which could have a significant and adverse effect on our business.

We are obligated to evaluate our internal controls over financial reporting in order to allow management to report on, and our independent auditors to opine on, our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and the rules and regulations of the SEC, which we collectively refer to as Section 404. In our Section 404 evaluation, we have identified areas of internal controls that may need improvement and have instituted remediation efforts where necessary. Currently, none of our identified areas that need improvement has been categorized as material weaknesses. We may identify conditions that may result in significant deficiencies or material weaknesses in the future.

We may be unable to protect our registered trademark or other proprietary intellectual property rights.

Our success depends to a significant degree upon the protection of the *Travelzoo* brand name. We rely upon a combination of copyright, trade secret and trademark laws, as well as non-disclosure and other contractual arrangements to protect our intellectual property rights. The steps we have taken to protect our proprietary rights, however, may not always succeed in deterring misappropriation of proprietary information.

We have registered the *Travelzoo* trademark in the U.S., Australia, Canada, China, Hong Kong, Japan, South Korea, Taiwan, the EU and the U.K. If we are unable to protect our rights in the mark in North America, Europe, and Asia Pacific, where we have licensed the trademark as described above under overview, a key element of our strategy of promoting *Travelzoo* as a brand could be disrupted and our business could be adversely affected. We may not always be able to detect unauthorized use of our proprietary information or take appropriate steps to enforce our intellectual property rights. In addition, the validity, enforceability, and scope of protection of intellectual property in Internet-related industries are uncertain and still evolving. The laws of countries in which we may market our services in the future are uncertain and may afford little or no effective protection of our intellectual property. The unauthorized reproduction or other misappropriation of our proprietary technology could enable third parties to benefit from our technology and brand name without paying us for them. If this were to occur, our business could be materially adversely affected.

We may face liability from intellectual property litigation that could be costly to prosecute or defend and distract management's attention with no assurance of success.

We cannot be certain that our products, content and brand names do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. While we have a trademark for *Travelzoo*, many companies in the industry have similar names including the word *travel*. We expect that infringement claims in our markets will increase in number as more participants enter the markets. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. We may incur substantial expenses in defending against these third party infringement claims, regardless of their merit, and such claims could result in a significant diversion of the efforts of our management personnel. Successful infringement claims against us may result in monetary liability or a material disruption in the conduct of our business.

Table of Contents**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We believe that our potential exposure to changes in market interest rates is not material. The Company has no outstanding debt and is not a party to any derivatives transactions. We invest in highly liquid investments with short maturities. Accordingly, we do not expect any material loss from these investments.

Our operations in Canada expose us to foreign currency risk associated with agreements being denominated in Canadian Dollars. Our operations in Europe expose us to foreign currency risk associated with agreements being denominated in British Pound Sterling and Euros. We are exposed to foreign currency risk associated with fluctuations of these currencies as the financial position and operating results of our operations in Canada and Europe are translated into U.S. Dollars for consolidation purposes. We do not use derivative instruments to hedge these exposures. We are a net receiver of U.S. Dollars from our foreign subsidiaries and therefore benefit from a weaker U.S. dollar and are adversely affected by a stronger U.S. dollar relative to the foreign currency used by the foreign subsidiary as its functional currency. We have performed a sensitivity analysis as of March 31, 2012, using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to the U.S. dollar with all other variables held constant. The foreign currency exchange rates we used were based on market rates in effect at March 31, 2012. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in an incremental \$101,000 foreign exchange loss for the three month periods ended March 31, 2012.

Item 4. Controls and Procedures

For the period ended March 31, 2012, we carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer along with the Company's Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e) and 15d-15(e). Based upon that evaluation, the Company's Chief Executive Officer along with the Company's Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2012 to ensure that the information required to be disclosed by us in this quarterly report was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and were also effective to ensure that information required to be disclosed by us in this quarterly report was accumulated and communicated to our management including the Company's Chief Executive Officer and the Company's Chief Financial Officer to allow timely decisions regarding its disclosure.

During the three months ended March 31, 2012, there was no change in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION**Item 1. Legal Proceedings**

The information set forth under Note 5 Commitments and Contingencies to the condensed consolidated financial statements included in Part I, Item 1 of this report is incorporated herein by reference.

Item 1A. Risk Factors

An updated description of the risk factors associated with our business is included under Risk Factors in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 2 of Part I of this report. This description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Item 1A of our 2011 Annual Report on Form 10-K and is incorporated herein by reference.

Item 6. Exhibits

The following table sets forth a list of exhibits:

Edgar Filing: TRAVELZOO INC - Form 10-Q

Exhibit

| Number | Description |
|---------------|---|
| 3.1 | Certificate of Incorporation of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002) |
| 3.2 | By-laws of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002) |
| 10.1 | Form of Director and Officer Indemnification Agreement (Incorporated by reference to Exhibit 10.1 on Form 10-Q (File No. 000-50171), filed November 9, 2007) |

Table of Contents

| Exhibit | |
|----------------|---|
| Number | Description |
| 10.12* | Nonqualified Stock Option Agreement between Travelzoo Inc. and Glen Ceremony and Shirley Tafoya dated January 23, 2012 (Incorporated by reference to Exhibits 10.1 and 10.2 on Form 8-K (File No. 000-50171), filed March 30, 2012) |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

* This exhibit is a management contract or a compensatory plan or arrangement.
 Filed herewith
 Furnished herewith

Table of Contents

SIGNATURE

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

TRAVELZOO INC.
(Registrant)

By: /s/ GLEN CEREMONY
Glen Ceremony
On behalf of the Registrant and as Chief Financial Officer

and Principal Accounting Officer

Date: April 27, 2012