

TRAVELZOO INC

FORM 10-Q (Quarterly Report)

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Industry	Computer Services
Sector	Technology
Fiscal Year	12/31

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

Form 10-Q

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

For the quarterly period ended September 30, 2004

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)

DELAWARE

*(State or other jurisdiction of
incorporation or organization)*

590 Madison Avenue, 21st Floor,

New York, New York

(Address of principal executive offices)

36-4415727

*(I.R.S. Employer
Identification No.)*

10022

(Zip Code)

Registrant's telephone number, including area code: **(212) 521-4200**

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 is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

As of November 11, 2004, the registrant had outstanding 16,233,204 shares of its \$0.01 par value common stock.

TRAVELZOO INC.

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PART I—FINANCIAL INFORMATION

Item 1. *Unaudited Condensed Consolidated Financial Statements*

TRAVELZOO INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	<u>September 30, 2004</u>	<u>December 31, 2003</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 6,077,758	\$3,521,637
Accounts receivable, less allowance for doubtful accounts of \$164,478 and \$71,459 as of September 30, 2004 and December 31, 2003, respectively	4,844,943	2,369,915
Deposits	20,280	97,086
Prepaid expenses and other current assets	285,950	131,618
Deferred income taxes	225,270	225,270
 Total current assets	 <u>11,454,201</u>	 <u>6,345,526</u>
Deposits, less current portion	141,638	42,525
Deferred income taxes	27,552	27,552
Property and equipment, net	128,978	164,034
Intangible assets, net	100,071	146,793
 Total assets	 <u>\$11,852,440</u>	 <u>\$6,726,430</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 307,883	\$ 223,627
Accrued expenses	1,739,404	1,328,537
Deferred revenue	176,892	22,312
Income tax payable	205,101	1,310,874
 Total liabilities	 <u>2,429,280</u>	 <u>2,885,350</u>
Commitments and Contingencies		
Stockholders' equity:		
Common stock	154,448	194,251
Additional paid-in capital	1,196,992	(116,078)
Retained earnings	8,071,720	3,762,907
 Total stockholders' equity	 <u>9,423,160</u>	 <u>3,841,080</u>
 Total liabilities and stockholders' equity	 <u>\$11,852,440</u>	 <u>\$6,726,430</u>

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenues	\$ 9,507,188	\$ 4,785,427	\$23,170,610	\$12,790,363
Cost of revenues	183,542	93,645	528,977	257,814
Gross profit	9,323,646	4,691,782	22,641,633	12,532,549
Operating expenses:				
Sales and marketing	4,338,518	2,525,638	11,462,392	6,744,080
General and administrative	1,437,017	1,115,144	3,653,119	3,074,947
Total operating expenses	5,775,535	3,640,782	15,115,511	9,819,027
Income from operations	3,548,111	1,051,000	7,526,122	2,713,522
Other income and expenses:				
Interest income	9,090	3,187	20,868	8,324
Other expense	220,135	—	220,135	—
Total other income and expenses, net	211,045	3,187	199,267	8,324
Income before income taxes	3,337,066	1,054,187	7,326,855	2,721,846
Income taxes	1,371,250	437,581	3,018,042	1,124,230
Net income	\$ 1,965,816	\$ 616,606	\$ 4,308,813	\$ 1,597,616
Basic net income per share	\$ 0.13	\$ 0.03	\$ 0.25	\$ 0.08
Diluted net income per share	\$ 0.11	\$ 0.03	\$ 0.23	\$ 0.08
Shares used in computing basic net income per share	15,448,204	19,425,147	17,111,490	19,425,147
Shares used in computing diluted net income per share	17,292,962	20,521,014	18,561,924	20,508,073

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net income	\$ 4,308,813	\$1,597,616
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	120,686	124,510
Provision for losses on accounts receivable	111,519	6,152
Loss on disposal of property and equipment	—	415
Tax benefit of stock option exercises	943,110	—
Changes in operating assets and liabilities:		
Accounts receivable	(2,586,547)	(831,275)
Deposits	(22,307)	(47,194)
Prepaid expenses and other current assets	(154,332)	(62,480)
Accounts payable	84,256	(82,452)
Accrued expenses	410,867	726,467
Deferred revenue	154,580	42,405
Income tax payable	(1,105,773)	326,568
Net cash provided by operating activities	<u>2,264,872</u>	<u>1,800,732</u>
Cash flows from investing activities:		
Purchases of property and equipment	(38,908)	(47,039)
Net cash used in investing activities	<u>(38,908)</u>	<u>(47,039)</u>
Cash flows from financing activities:		
Issuance of common stock	295,767	—
Recovery of profit from purchase and sale of stock by employees	34,390	—
Net cash provided by financing activities	<u>330,157</u>	<u>—</u>
Net increase in cash and cash equivalents	2,556,121	1,753,693
Cash and cash equivalents at beginning of period	3,521,637	1,258,273
Cash and cash equivalents at end of period	<u>\$ 6,077,758</u>	<u>\$3,011,966</u>
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 3,180,705	\$ 797,662

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) The Company and Basis of Presentation

Travelzoo Inc. (the “Company” or “Travelzoo”) is an Internet media company. The Company’s publications include the *Travelzoo* Web site, the *Travelzoo Top 20* e-mail newsletter, and the *Newsflash* e-mail product. The Company also operates *SuperSearch*, a pay-per-click travel search engine.

Travelzoo is controlled by Ralph Bartel, who held approximately 83% of the outstanding shares as of November 11, 2004.

The accompanying unaudited condensed consolidated financial statements have been prepared by Travelzoo Inc. in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosure 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, 2003, included in the Company’s Form 10-K filed with the SEC on March 29, 2004.

The 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.

The results of operations for the nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004 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, Mr. 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 stockholders for no cash consideration (“Netsurfer shares”). In 1998, Mr. Bartel also founded Silicon Channels Corporation, a California corporation, to operate the *Travelzoo* Web site. 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 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. The merger was accounted for as a combination of entities under common control using “as-if pooling-of-interests” accounting. Under this method of accounting, the assets and liabilities of Silicon Channels Corporation and Travelzoo Inc. were carried forward to the combined company at their historical costs. In addition, all prior period financial statements of Travelzoo Inc. were restated to include the combined results of operations, financial position and cash flows of Silicon Channels Corporation.

During January 2001, the Board of Directors of Travelzoo.com Corporation proposed that Travelzoo.com Corporation be merged with Travelzoo Inc. whereby Travelzoo Inc. would be the surviving entity. On March 15, 2002, the stockholders of Travelzoo.com Corporation approved the merger with Travelzoo Inc. On April 25, 2002, the certificate of merger was filed in Delaware upon which the merger became effective and Travelzoo.com Corporation ceased to exist. Each outstanding share of common stock of Travelzoo.com Corporation was converted into the right to receive one share of common stock of 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 shares of Travelzoo Inc. 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. As of September 30, 2004, there were 15,448,204 shares of common stock outstanding.

and earnings per share calculations reflect the reduction of the number of shares reported as outstanding during the period.

It is possible that claims may be asserted against the Company in the future by former stockholders of Travelzoo.com Corporation seeking to receive shares in the Company, whether based on a claim that the two-year deadline for exchanging their shares was unenforceable or otherwise. In addition, one or more jurisdictions, including the Bahamas or the State of Delaware, may assert rights to unclaimed shares of the Company under escheat statutes. If such escheat claims are asserted, the Company intends 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 their rights to receive their shares expired two years following the effective date of the merger, as provided in the merger agreement. The Company also expects to take the position, if escheat or similar claims are asserted in respect of the unissued shares in the future, that it is not required to issue such shares. Further, even if it were established that unissued shares were subject to escheat claims, the Company would assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. The Company is not able to predict the outcome of any future claims which might be asserted relating to the unissued shares. If such claims were asserted, and were fully successful, that could result in the Company's being required to issue up to an additional 4,115,532 shares of common stock for no additional payment.

On October 15, 2004, the Company announced a program under which it will make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for shares in Travelzoo Inc. within the required time period. The accompanying unaudited financial statements include a liability of \$220,135 charged to other expenses during the three months ended September 30, 2004. The liability amount is based on management's best estimate as of the reporting date of the minimum loss that is probable to be paid in the future as a result of this program. The total liability incurred under 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. 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 merger of Travelzoo.com Corporation into Travelzoo Inc. was accounted for as a combination of entities under common control using "as-if pooling-of-interests" accounting. Under this method of accounting, the assets and liabilities of Travelzoo.com Corporation and Travelzoo Inc. were carried forward at their historical costs. In addition, all prior period financial statements of Travelzoo Inc. were restated to include the combined results of operations, financial position and cash flows of Travelzoo.com Corporation. The restated results of operations and cash flows of Travelzoo Inc. are identical to the combined results of Travelzoo.com Corporation and Travelzoo Inc.

(2) Revenue Recognition

Substantially all revenue consists of advertising sales. Advertising revenues are derived from the sale of advertising in the Company's publications and in *SuperSearch*, a pay-per-click travel search engine.

Advertising revenues are recognized in the period in which the advertisement is displayed, provided that evidence of an arrangement exists, the fees are fixed or determinable, no significant obligations remain at the end of the period, and collection of the resulting receivable is reasonably assured. Where collectibility is not reasonably assured, the revenue will be recognized upon cash collection, provided that the other criteria for revenue recognition have been met. If fixed-fee advertising is displayed over a term extending beyond a reporting period, revenues are recognized ratably over the period. To the extent that any minimum guaranteed impressions are not met during the contract period, the Company defers recognition of the corresponding revenues until the guaranteed impressions are achieved. Fees for banner advertising and other variable-fee advertising arrangements are recognized based on the number of impressions displayed or clicks delivered during the period.

Under these policies, no revenue is recognized unless persuasive evidence of an arrangement exists, delivery has 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 a non-cancelable insertion order signed by the client or its agency to be evidence of an arrangement.

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- *Delivery.* Delivery is considered to occur when the advertising has been displayed and, if applicable, the click-throughs have been delivered.
- *Fixed or determinable fee.* We consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment.
- *Collection is deemed reasonably assured.* We conduct a credit review for all significant transactions at the time of the arrangement to determine the creditworthiness of the client. Collection is deemed reasonably assured if we expect that the client 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 a client 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.

During the three months ended September 30, 2004, the Company recognized no revenue on a cash-received basis. As of September 30, 2004, the Company deferred recognition of \$57,000 of advertising delivered during the three months ended September 30, 2004 for which collectibility was not reasonably assured. Such revenue will be recognized in future periods when and if collected.

Our standard payment terms are 30 days net. We invoice our clients monthly. Insertion orders that include fixed-fee advertising are invoiced on the first day of the month. Insertion orders that include variable-fee advertising are invoiced on the first business day following the end of the month. Our standard terms state that in the event that Travelzoo fails to publish advertisements as specified in the insertion order, the liability of Travelzoo to the advertiser shall be limited to, at Travelzoo's sole discretion, a pro rata refund of the advertising fee, the placement of the advertisements at a later time in a comparable position, or the extension of the term of the insertion order until the advertising is fully delivered. The company believes that no significant obligations exist after the full delivery of advertising.

Revenues for advertising sold to clients through agencies are reported at the net amount billed to the agency.

(3) Stock-based Compensation

The Company did not provide any stock-based compensation in fiscal year 2003 or in the nine months ended September 30, 2004. In addition, all previously issued options vested prior to January 1, 2002 and therefore there are no applicable disclosures under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, as amended.

(4) Net Income Per Share

Net income per share has been calculated under SFAS No. 128, *Earnings per Share*. Basic net income per share is computed by dividing the net income by the weighted-average number of reported common shares outstanding for the period. Diluted net income per share is computed by dividing net income by the weighted-average number of reported common shares and potential common shares outstanding during the period. Potential common shares included in the diluted calculation consists 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 per share:

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Basic net income per share:				
Net income	\$ 1,965,816	\$ 616,606	\$ 4,308,813	\$ 1,597,616
Weighted average common shares	15,448,204	19,425,147	17,111,490	19,425,147
Basic net income per share	\$ 0.13	\$ 0.03	\$ 0.25	\$ 0.08
Diluted net income per share:				
Net income	\$ 1,965,816	\$ 616,606	\$ 4,308,813	\$ 1,597,616
Weighted average common shares	15,448,204	19,425,147	17,111,490	19,425,147
Effect of dilutive securities: stock options	1,844,758	1,095,867	1,450,434	1,082,926
Diluted weighted average common shares	17,292,962	20,521,014	18,561,924	20,508,073
Diluted net income per share	\$ 0.11	\$ 0.03	\$ 0.23	\$ 0.08

(5) Commitments and Contingencies

The Company leases office space in Chicago, Miami, Mountain View (California), and New York, under operating leases which expire on July 31, 2005, December 31, 2005, December 31, 2005 and December 31, 2005, respectively. The future minimum rental payments under these operating leases as of September 30, 2004, and December 31, 2003 total \$1,242,606 and \$827,638, respectively. The future lease payments consist of \$255,123 of payments due in 2004 and \$987,483 of payments due in 2005.

As described in note 1, the Company has recorded a liability of \$220,135 as of September 30, 2004 as its best estimate of the minimum loss that is probable to be paid as a result of the announced program to make cash payments to former stockholders of Travelzoo.com Corporation. The total liability incurred under 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. 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.

(6) Significant Customer Information and Segment Reporting

SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, establishes standards for the reporting by business enterprises of information about operating segments, products and services, geographic areas, and major customers. The method for determining what information to report is based on the way that management organizes the operating segments within a company for making operational decisions and assessing performance. As of September 30, 2004, the Company has one operating segment.

Significant customer information is as follows:

Customer	Percent of Revenues		Percent of Accounts Receivable	
	Nine Months Ended September 30,		September 30,	December 31,
	2004	2003	2004	2003
A	10%	*	20%	*
B	*	12%	12%	14%
C	*	11%	13%	*

All of the above customers are located in the United States of America.

* Less than 10%

(7) Subsequent Events

In October 2004, the Company completed a private placement offering of 750,000 newly-issued shares of common stock for gross proceeds

of \$30.0 million to a group of investors. The proceeds from the offering are intended to be used for general corporate purposes, including new product development and marketing expenditures, and potential acquisitions or strategic investments.

In October 2004, the Company announced a program to make cash payments to former stockholders of Travelzoo.com Corporation. As a result, the Company recorded a liability of \$220,135 as of September 30, 2004. See note 1 for further details.

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”, “potential”, “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 Securities and Exchange Commission (“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.

Overview

Travelzoo Inc. is an Internet media company. As the Internet is becoming consumers’ preferred medium to search for travel offers, we provide airlines, hotels, cruise lines, vacation packagers, and other travel companies with a fast, flexible, and cost-effective way to reach millions of users. While our products provide advertising opportunities for travel companies, they also provide Internet users with a free source of information on current offers from hundreds of travel companies. Our publications include the *Travelzoo* Web site, the *Travelzoo Top 20* e-mail newsletter, and the *Newsflash* e-mail product. We also operate *SuperSearch*, a pay-per-click travel search engine. More than 300 travel companies purchase our advertising services.

Our revenues are advertising revenues, consisting of listing fees paid by travel companies to advertise their offers on the *Travelzoo* Web site, in the *Travelzoo Top 20* e-mail newsletter, through the *Newsflash* e-mail alert service and through the *SuperSearch* pay-per-click search engine, and banner advertising sales. Revenues are principally generated from the sale of advertising on our *Travelzoo* Web site and in our *Travelzoo Top 20* newsletter. Listing fees are based on placement, number of listings, number of impressions, or number of click-throughs. Banner advertising rates are based on CPM rates (cost per thousand impressions). Smaller advertising agreements — typically \$2,000 or less per month — typically renew automatically each month if they are not terminated by the client. Larger agreements are typically related to advertising campaigns and are not automatically renewed.

When evaluating the financial condition and operating performance of the Company, management focuses on the following financial and non-financial indicators:

- Growth of number of subscribers of the Company’s e-mail products and page views of selected sections of the *Travelzoo* Web site;
- Growth in revenues in the absolute and relative to the growth in reach of the Company’s products;
- Pre-tax profitability; and
- Revenue per employee as a measure of productivity.

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 and the allowance for doubtful accounts. These policies, and our procedures related to these policies, are described below.

Revenue Recognition

We recognize advertising revenues in the period in which the advertisement is displayed, provided that evidence of an arrangement

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exists, the fees are fixed or determinable, no significant obligations remain at the end of the period, and collection of the resulting receivable is deemed reasonably assured. If fixed-fee advertising is displayed over a term greater than one month, revenues are recognized ratably over the period. To the extent that any minimum guaranteed impressions are not met during the contract period, the Company defers recognition of the corresponding revenues until the guaranteed impressions are achieved. Fees for banner advertising and other variable-fee advertising arrangements are recognized based on the number of impressions displayed or clicks delivered during the period.

Under these policies, no revenue is recognized unless persuasive evidence of an arrangement exists, delivery has 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 a non-cancelable insertion order signed by the client 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.
- *Fixed or determinable fee.* We consider the fee to be fixed or determinable if the fee is not subject to refund or adjustment.
- *Collection is deemed reasonably assured.* We conduct a credit review for all significant transactions at the time of the arrangement to determine the creditworthiness of the client. Collection is deemed reasonably assured if we expect that the client 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.

During the three months ended September 30, 2004, the Company recognized no revenue on a cash-received basis. As of September 30, 2004, the Company deferred recognition of \$57,000 of advertising delivered during the three months ended September 30, 2004 for which collectibility was not reasonably assured. Such revenue will be recognized in future periods when and if collected.

Our standard payment terms are 30 days net. We invoice our clients monthly. Insertion orders that include fixed-fee advertising are invoiced on the first day of the month. Insertion orders that include variable-fee advertising are invoiced on the first business day following the end of the month. Our standard terms state that in the event that Travelzoo fails to publish advertisements as specified in the insertion order, the liability of Travelzoo to the advertiser shall be limited to, at Travelzoo's sole discretion, a pro rata refund of the advertising fee, the placement of the advertisements at a later time in a comparable position, or the extension of the term of the insertion order until the advertising is fully delivered. The company believes that no significant obligations exist after the full delivery of advertising.

Revenues for advertising sold to clients through agencies is reported at the net amount billed to the agency.

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 client, the economic conditions of the client'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 clients were to deteriorate, affecting their ability to make payments, additional provision for doubtful accounts may be required.

Results of Operations

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

Revenues

Our total revenues increased to \$9.5 million for the three months ended September 30, 2004 from \$4.8 million for the three months ended September 30, 2003. Our total revenues increased to \$23.0 million for the nine months ended September 30, 2004 from \$12.8 million for the nine months ended September 30, 2003. This represents an increase of 81%. The increase was primarily due to an increase in the number of advertisers. Also contributing to the increase was an increase in our advertising rates on January 1, 2004.

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Management believes that our ability to increase revenues in the future depends mainly on three factors:

- Our ability to increase our advertising rates;
- Our ability to sell more advertising to existing advertisers; and
- Our ability to increase the number of advertisers.

We believe that we can increase our advertising rates only if the reach of our publications increases. We do not know if we are able to increase the reach of our publications. 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 online advertising continues to grow. We do not know if we will be able to maintain or increase our market share. We historically increased the number of advertisers in every year since inception. We do not know if we will be able to increase the number of advertisers in the future.

Average annualized revenue per employee increased to \$776,000 for the three months ended September 30, 2004 from \$532,000 for the three months ended September 30, 2003.

Cost of Revenues

Cost of revenues consists of network expenses, including fees we pay for co-location services, depreciation of network equipment, salary expenses associated with network operations staff, and fees for photos used in our publications. Our cost of revenues increased to \$184,000 for the three months ended September 30, 2004 from \$94,000 for the three months ended September 30, 2003. Our cost of revenues increased to \$529,000 for the nine months ended September 30, 2004 from \$258,000 for the nine months ended September 30, 2003. As a percentage of revenue, cost of revenues remained the same, 2%, for the nine months ended September 30, 2004 and for the nine months ended September 30, 2003.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of advertising and promotional expenses, public relations expenses, conference expenses, and salary expenses associated with sales and marketing staff. Sales and marketing expenses increased to \$4.3 million for the three months ended September 30, 2004 from \$2.5 million for the three months ended September 30, 2003. Sales and marketing expenses increased to \$11.5 million for the nine months ended September 30, 2004 from \$6.7 million for the nine months ended September 30, 2003. The increase in sales and marketing expenses was primarily due to increases of our advertising campaigns. The goal of our advertising was to acquire new subscribers for our e-mail products and to increase brand awareness for *Travelzoo*. For the nine months ended September 30, 2004 and 2003, advertising expenses accounted for 74% and 70%, respectively, of sales and marketing expenses. Advertising activities during these periods consisted primarily of online advertising. The increase in sales and marketing expenses in the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003 was also due to an increase in headcount of our sales force.

It's our goal to increase our revenues from advertising sales. One important factor that drives our revenues are our advertising rates. We believe that we can increase our advertising rates only if the reach of our publications increases. In order to increase the reach of our publications, we have to acquire a significant number of new subscribers in every quarter. Therefore, we expect our sales and marketing expenses as a percentage of revenue to remain at the current level or increase from the current level. The main factor that impacts our advertising expenses is the average cost per acquisition of a new subscriber. 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.

General and Administrative

General and administrative expenses consist primarily of compensation for administrative and executive staff, fees for professional services, rent, bad debt expense, amortization of intangible assets and general office expense. General and administrative expenses increased to \$1.4 million for the three months ended September 30, 2004 from \$1.1 million for the three months ended September 30, 2003. General and administrative expenses increased to \$3.7 million for the nine months ended September 30, 2004 from \$3.1 million for the nine months ended September 30, 2003. The increase in general and administrative expenses was due mainly to an increase of office space to accommodate the increase in headcount. 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 general and administrative expenses to continue to increase.

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Other Expenses

In the three months ended September 30, 2004, the Company recorded a liability of \$220,135 related to a program under which the Company intends to make cash payments to former stockholders of Travelzoo.com Corporation, who failed to submit requests for shares in Travelzoo Inc. within the required time period. The liability amount is based on management's best estimate as of the reporting date of the minimum loss that is probable to be paid in the future as a result of the program. Changes in management's estimate, which is based on the number of estimated valid claims received and the Company's stock price, will result in additional other income and expense in future periods.

Income Taxes

For the three months ended September 30, 2004, we recorded an income tax provision of \$1.4 million. For the three months ended September 30, 2003, we recorded an income tax provision of \$438,000. For the nine months ended September 30, 2004, we recorded an income tax provision of \$3.0 million. For the nine months ended September 30, 2003, we recorded an income tax provision of \$1.1 million. Our income is generally taxed in the U.S. and our income tax provisions reflect federal and state statutory rates applicable to our levels of income. Our effective tax rate fluctuated in years prior to 2004 because merger expenses and stock offering costs reported as expenses in the consolidated financial statements were not deductible for tax purposes and thereby increased the effective tax rate for financial reporting purposes in those periods. The effective tax rate for interim periods in 2004 is based on the annual effective tax rate for 2004 of 41% which approximates U.S. federal and state statutory rates.

During the second quarter of 2004, the Company realized a tax benefit of \$943,000 upon the exercise of stock options by directors. The tax benefit reduced the Company's income tax payable and increased additional paid-in capital by this amount.

Stockholders' Equity

As described in Note 1 to the condensed consolidated financial statements, on April 25, 2004, the two-year period for former stockholders of Travelzoo.com Corporation to receive shares of Travelzoo Inc. expired. On that date, the number of common shares reported as outstanding was reduced by the number of unissued shares.

In June 2004, an aggregate of 138,589 shares of common stock were issued to current and former directors upon the exercise of fully vested options. The options were granted in 2001 and 2002 to directors for their services as directors in 2000, 2001, and 2002.

Liquidity and Capital Resources

As of September 30, 2004, we had \$6.1 million in cash and cash equivalents. Cash and cash equivalents increased from \$3.5 million on December 31, 2003 primarily as a result of cash provided by operations as explained below. In October 2004, we completed the private placement sale of 750,000 shares of common stock for gross proceeds of \$30.0 million. We expect that cash on hand and cash flows generated from operations will be sufficient to provide for working capital needs for at least the next 12 months.

Net cash provided by operating activities in the nine months ended September 30, 2004 was \$2.3 million. Net cash provided by operating activities in the nine months ended September 30, 2003 was \$1.8 million. In the nine months ended September 30, 2004, net cash provided by operating activities resulted primarily from net income offset by an increase in accounts receivable and a decrease in income tax payable. Accounts receivable as a percentage of revenue increased primarily because of a larger portion of insertion orders which include variable-fee advertising, particularly advertising in our *SuperSearch* product. If revenues from *SuperSearch* continue to increase as a percentage of revenues, we expect the increase of accounts receivable as a percentage of revenue to continue. The decrease in income tax payable was primarily due to estimated payments on current federal and state income tax liabilities. In the nine months ended September 30, 2003, net cash provided by operating activities resulted primarily from net income and an increase in accrued expenses offset by an increase in accounts receivable.

Net cash used in investing activities was \$39,000 and \$47,000 during the nine months ended September 30, 2004 and September 30, 2003, respectively. In both periods, net cash was used in investing activities for equipment purchases.

Net cash provided by financing activities was \$330,000 during the nine months ended September 30, 2004. There were no cash

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flows related to financing activities in the nine months ended September 30, 2003. In the nine months ended September 30, 2004, net cash provided by financing activities resulted primarily from exercises of stock options.

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 and launch of new products such as our *SuperSearch* pay-per-click search engine, the expansion of our operations and the amount of our resources we devote to promoting awareness of the *Travelzoo* brand. Consistent with our growth, we have experienced a substantial increase in our sales and marketing expenses since inception, and we anticipate that these increases will continue for the foreseeable future. We believe cash on hand and generated during those periods will be sufficient to pay such costs. 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.

We currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements beyond the next 12 months. However, if unanticipated events occur, or if we have opportunities to issue equity or debt securities on favorable terms, we may elect to issue additional equity or debt securities or establish new credit facilities. 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.

The following summarizes our principal contractual commitments as of September 30, 2004 (in thousands):

	2004	2005	2006	2007	2008	Thereafter	Total
Operating leases	\$255	\$ 987	—	—	—	—	\$1,242
Purchase obligations	27	45	—	—	—	—	72
Total commitments	\$282	\$1,032	—	—	—	—	\$1,314

As of September 30, 2004, we have recorded a liability of \$220,135 for the estimated minimum liability that is probable to be paid under a program to make cash payments to former stockholders of *Travelzoo.com* Corporation. The total liability incurred under 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. 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.

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

Our limited operating history makes our business difficult to evaluate.

We have only a limited operating history for you to consider in evaluating our business. As a young company, we face risks and uncertainties relating to our ability to successfully implement our business plan. You must consider the risks, expenses and uncertainties which can materially affect the business of a young company like ours. These risks include uncertainty whether we will be able to:

- increase awareness of the *Travelzoo* brand;
- attract and retain additional travel companies to list their special offers with us;
- attract additional Internet users to the *Travelzoo* Web site ;
- increase the functionality of our products and services;

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- maintain our current, and develop new, business relationships;
- respond effectively to competitive pressures; and
- continue to develop and upgrade our technology.

We cannot assure you that we will sustain profitability.

Although we have been profitable in the past, there is no assurance that we will continue to be profitable. We forecast our future expense levels based on our operating plans and our estimates of future revenues. We may find it necessary to accelerate expenditures relating to our sales and marketing efforts or otherwise increase our financial commitment to creating and maintaining brand awareness among travel companies and Internet users. 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 sustain profitability. In this case, the value of the shares of Travelzoo could be reduced.

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

Our quarterly 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 quarter. 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;
- the maintenance and development of our strategic relationships;
- 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;
- our ability to manage our anticipated growth and expansion;
- our ability to attract traffic to our Web site;
- technical difficulties or system downtime affecting the Internet generally or the operation of our products and services specifically; and
- payments which we make to previous stockholders of Travelzoo.com Corporation who failed to submit requests for shares in Travelzoo Inc. within the required time period.

In addition, we plan to significantly increase our operating expenses related to advertising campaigns for *Travelzoo* and the expansion of our sales and production departments. If revenues fall below our expectations in any quarter and we are unable to quickly reduce our spending in response, our operating results would be lower than expected and our stock price may fall.

In addition, we are required under Generally Accepted Accounting Principles to review our intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We may be required to record a significant expense or charge to earnings in our financial statements in the period any impairment of intangible assets is determined.

We depend on two clients for a substantial part of our revenues.

Two of our current clients have each represented a substantial portion of our business in the nine months ended September 30, 2004 and the year ended December 31, 2003. One client has accounted for as much as 11% of our revenue and another client has accounted for as much as 10% of our revenue in those periods. The loss of one client or both clients may result in a significant decrease in our revenues and results of operations, which could have a material adverse effect on our business.

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

Our current revenue model depends on advertising fees paid by travel companies. If current clients decide not to continue advertising their

sales and specials with us and we are unable to replace them with new clients, our business may be adversely

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affected. To be successful, we must provide online marketing solutions that achieve broad market acceptance by travel 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.

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.

We intend to continue to grow our business, and intend to fund our current operations and our anticipated growth from the cash flow generated from our operations and our retained earnings. However, these sources may not be sufficient to meet our needs. We may not be able to obtain additional 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, the terms of these securities could restrict or prevent us from paying dividends and could limit our flexibility in making business decisions. In October 2004, we completed the private placement sale of 750,000 shares of common stock for gross proceeds of \$30.0 million.

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 dependent on the demand for online advertising from travel companies. The last recession decreased consumer travel and caused travel companies to reduce or postpone their marketing spending generally, and their online marketing spending in particular. If the current economic recovery does not continue, our business and financial condition could be materially adversely affected.

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, 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 in the event of 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, resulting 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. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events. Any such event could reduce our revenue and harm our operating results and financial condition.

Risks Related to Our Markets and Strategy

The Internet is not a proven marketing medium.

The future of our business is dependent on the continuing acceptance by travel companies of the Internet as an effective marketing tool, and on the ongoing acceptance by consumers of the Internet as a source for information on offers from travel companies. The adoption of online marketing by travel companies, particularly among those that have historically relied upon traditional advertising methods, requires the acceptance of a new way of conducting business, marketing and advertising. Many of our potential clients have little or no experience using the Internet as a marketing tool, and not all Internet users have experience using the Internet to book

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travel. As a result, we cannot be sure that we will be able to effectively compete with traditional advertising methods. If we are unable to compete with traditional advertising methods, our business and results of operations could be materially adversely affected.

We may not be able to develop awareness of our brand name.

We believe that continuing to build awareness of the *Travelzoo* brand name 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 brand, incur significant expenses in promoting our brand 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 name, our business could be materially adversely affected.

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

Events like the war with Iraq in 2003 or the terrorist attacks on the United States in 2001 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 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 the events result in a long-term negative impact on the travel industry, such impact could have a material adverse effect on our business.

We will not be able to attract travel 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 companies and Internet users find attractive. This could reduce the number of travel companies and Internet users using our products and materially adversely affect our business.

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

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We have recently experienced a period of rapid growth. In order to execute our business plan, we must continue to grow significantly. As of September 30, 2004, we had 49 employees. 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 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 with large Internet portal sites, such as About.com, America Online, Lycos, MSN and Yahoo!, that offer listings or other advertising opportunities for travel companies. These companies have significantly greater financial, technical, marketing and other resources and larger client bases. We also compete with search engines like Google and Overture that offer pay-per-click listings. In addition, we compete with newspapers, magazines and other traditional media companies that 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 travel companies 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 Ralph Bartel, our Chairman, President, Chief Executive Officer, Chief Financial Officer and Secretary. 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.

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. 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 first six months of 2004, the sale prices of our common stock on the NASDAQ SmallCap Market ranged from \$7.10 to \$31.47 per share. Since our inclusion on the NASDAQ National Market in August 2004, the sale prices of our common stock on the NASDAQ National Market ranged from \$30.06 to \$105.23. 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.

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Ralph Bartel, who founded Travelzoo and who is our Chairman of the Board, President, Chief Executive Officer, Chief Financial Officer and Secretary, is our largest stockholder, holding approximately 83% of our outstanding shares with options to increase his percentage ownership to 85% on a fully-diluted basis. 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 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;
- sales and other taxes; and
- other claims based on the nature and content of Internet materials.

Claims may be asserted against us relating to shares not issued in our recent merger.

The merger of Travelzoo.com Corporation into the Company became effective on April 25, 2004. Stockholders of Travelzoo.com Corporation were allowed a period of two years following the effective date to receive shares of the Company. After April 25, 2004, two years following the effective date, the Company 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 shares of the Company which had been reserved for issuance in the merger were not claimed.

It is possible that claims may be asserted against the Company in the future by former stockholders of Travelzoo.com Corporation seeking to receive shares in the Company, whether based on a claim that the two-year deadline for exchanging their shares was unenforceable or otherwise. In addition, one or more jurisdictions, including the Bahamas or the State of Delaware, may assert rights to unclaimed shares of the Company under escheat statutes. If such escheat claims are asserted, the Company intends to challenge the applicability of escheat rights, among other reasons, in that 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 their rights to receive their shares expired two years following the effective date of the merger, as provided in the merger agreement. The Company also expects to take the position, if escheat or similar claims are asserted in respect of the unissued shares in the future, that it is not required to issue such shares. Further, even if it were established that unissued shares were subject to escheat claims, the Company

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would assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares. The Company is not able to predict the outcome of any future claims which might be asserted relating to the unissued shares. If such claims were asserted, and were fully successful, that could result in the Company's being required to issue up to an additional 4,115,532 shares of common stock for no additional payment, which would result in substantial dilution of the ownership interests of the other stockholders, and in the Company's earnings per share, which could adversely affect the market price of the common stock.

In October 2004, the Company announced a program under which it will make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for shares in Travelzoo Inc. within the required time period referred to above. In the three months ended September 30, 2004, the Company recorded a liability of \$220,135 related to this program. The total future liability under this program is not reliably estimable because it will depend on the ultimate number of valid requests received and future levels of the Company's common stock price. The Company's common stock price affects the amount of this 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.

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 and 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 be adequate to deter misappropriation of proprietary information.

The U.S. Patent and Trademark Office registered the trademark for "Travelzoo" on January 23, 2001. If we are unable to protect our rights in the mark, 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 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 is uncertain and still evolving. The laws of other 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.

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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company has no outstanding debt, is not a party to any derivatives transactions, and does not have any other material liabilities or assets which are subject to risks relating to interest rates, currency exchange rates, commodity price risks or other market risks.

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Item 4. Controls and Procedures

As of September 30, 2004, we carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President, Chief Executive Officer and Chief Financial Officer along with the Company's Controller (Chief Accounting Officer), of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Company's President, Chief Executive Officer and Chief Financial Officer along with the Company's Controller (Chief Accounting Officer) concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in our periodic SEC filings as of September 30, 2004.

During the quarter ended September 30, 2004, 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 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On September 29, 2004, Travelzoo Inc. (the "Company") entered into a Common Stock Purchase Agreement between the Company and various investors (the "Agreement"), pursuant to which the Company issued 750,000 shares of its Common Stock, par value \$0.01, for a purchase price of \$40.00 per share and received gross proceeds of \$30,000,000, which the Company intends to use for general corporate purposes, including new product development and marketing expenditures, and potential acquisitions or strategic investments. The closing occurred on October 5, 2004 and a \$1,800,000 commission was paid in connection with this sale. The Agreement provides that the Company will file a registration statement with the U.S. Securities and Exchange Commission within 30 days of the closing of the transactions contemplated by the Agreement, and requires that the Company use all reasonable efforts to cause the registration statement to become effective within 120 days of the closing.

The issuance of the shares of Common Stock was made pursuant to the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"), and Regulation D promulgated thereunder. Each investor is an accredited investor under the Securities Act and the securities were sold without any general solicitation by the Company or its representatives.

Item 6. Exhibits

The following exhibits are filed as part of this report:

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)
31.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to 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, in the City of New York, State of New York, on November 15, 2004.

TRAVELZOO INC.
(Registrant)

By: /s/ RALPH BARTEL
Ralph Bartel
*Chairman of the Board, Chief Executive
Officer, and Chief Financial Officer*

By: /s/ LISA
Lisa Su
Controller (Chief Accounting Officer)

