TRAVELZOO INC
Form 10-Q
November 09, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

o **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	**36-4415727**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. employer identification no.)*
590 Madison Avenue, 21st Floor, New York, New York	**10022**
(Address of principal executive offices)	*(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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The number of shares of Travelzoo common stock outstanding as of November 1, 2006 was 15,250,479 shares.

Table of Contents

TRAVELZOO INC.
Table of Contents

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Unaudited Condensed Consolidated Financial Statements

TRAVELZOO INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except par value)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,977	$ 24,469
Short-term investments		19,887
Accounts receivable, less allowance for doubtful accounts of $650 and $418 as of September 30, 2006 and December 31, 2005, respectively	8,827	9,020
Deposits	22	28
Prepaid expenses and other current assets	577	631
Deferred income taxes	1,020	1,020
Total current assets	38,423	55,055
Deposits, less current portion	292	190
Deferred income taxes	28	28
Property and equipment, net	174	159
Intangible assets, net	1	20
Total assets	$ 38,918	$ 55,452
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,496	$ 2,373
Accrued expenses	3,150	3,394
Deferred revenue	579	296
Income tax payable	207	856
Total liabilities	6,432	6,919
Commitments and contingencies		
Stockholders equity:		
Common stock, $0.01 par value (40,000 shares authorized; 15,250 shares issued and outstanding as of September 30, 2006; 16,250 shares issued and outstanding as of December 31, 2005)	153	163
Additional paid-in capital	2,076	30,645
Retained earnings	30,281	17,763
Accumulated other comprehensive loss	(24)	(38)

Total stockholders equity		32,486		48,533
Total liabilities and stockholders equity	$	38,918	$	55,452

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 September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenues	$ 17,586	$ 13,384	$ 51,873	$ 36,871
Cost of revenues	232	225	782	629
Gross profit	17,354	13,159	51,091	36,242
Operating expenses:				
Sales and marketing	6,974	7,101	22,047	18,282
General and administrative	2,249	1,878	6,962	6,614
Total operating expenses	9,223	8,979	29,009	24,896
Income from operations	8,131	4,180	22,082	11,346
Other income and expense:				
Interest income	279	278	926	656
Gain (loss) on foreign currency	7	(4)	12	(8)
Income before income taxes	8,417	4,454	23,020	11,994
Income taxes	3,866	2,156	10,502	5,685
Net income	$ 4,551	$ 2,298	$ 12,518	$ 6,309
Basic net income per share	$ 0.30	$ 0.14	$ 0.80	$ 0.39
Diluted net income per share	$ 0.28	$ 0.13	$ 0.74	$ 0.35
Shares used in computing basic net income per share	15,250	16,250	15,595	16,249
Shares used in computing diluted net income per share	16,464	17,695	16,803	17,897

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

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

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 12,518	$ 6,309
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	103	126
Deferred income taxes		20
Provision for losses on accounts receivable	228	79
Tax benefit of stock option exercises		396
Accrued interest income	(449)	(268)
Changes in operating assets and liabilities:		
Accounts receivable	3	(3,050)
Deposits	(92)	(52)
Prepaid expenses and other current assets	63	296
Accounts payable	100	266
Accrued expenses	(271)	1,188
Deferred revenue	282	221
Income tax payable	(649)	619
Net cash provided by operating activities	11,836	6,150
Cash flows from investing activities:		
Purchases of property and equipment	(96)	(117)
Purchase of short-term investments	(14,663)	(29,691)
Sale of short-term investments	35,000	20,073
Net cash provided by (used in) investing activities	20,241	(9,735)
Cash flows from financing activities:		
Issuance costs incurred in connection with 2004 issuance of common stock		(124)
Proceeds from stock option exercises		35
Repurchase of common stock	(28,579)	
Net cash used in financing activities	(28,579)	(89)
Effect of exchange rate on cash and cash equivalents	10	(26)
Net increase (decrease) in cash and cash equivalents	3,508	(3,700)
Cash and cash equivalents at beginning of period	24,469	26,435
Cash and cash equivalents at end of period	$ 27,977	$ 22,735

Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 11,152	$ 4,650

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 an Internet media company. The Company s publications include the *Travelzoo* Web sites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, and www.travelzoo.de), the *Travelzoo Top 20* e-mail newsletter, and the *Newsflash* e-mail product. Travelzoo also operates *SuperSearch,* a pay-per-click travel search engine.

Travelzoo is controlled by Ralph Bartel, who held beneficially approximately 52% of the outstanding shares as of November 1, 2006.

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 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, 2005, included in the Company s Form 10-K filed with the SEC on March 16, 2006.

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. 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 and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006 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. 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. Earnings per share calculations reflect this reduction of the number of shares reported as outstanding. As of September 30, 2006, there were 15,250,479 shares of common stock outstanding.

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 being required to issue up to an additional approximately 4,074,000 shares of common stock for no additional payment.

On October 15, 2004, the Company announced a program under which it would 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 consolidated financial statements include a charge in general and administrative expenses of $124,000 for these cash payments for the nine months ended September 30, 2006 of which $5,000 remains as a liability as of September 30, 2006. The liability is based on the number of actual requests received from former stockholders through September 30, 2006 which had not yet been processed. 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. 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 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. 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. Assuming 100% of the requests from 1998 were valid, former stockholders of Travelzoo.com Corporation holding an additional approximately 4,074,000 shares had not submitted claims under the program as of September 30, 2006.

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.

Note 2: Revenue Recognition

All revenue consists of advertising sales. Advertising insertions are either sold by fixed-fee arrangements or sold by variable-fee arrangements.

The Company recognizes revenues in accordance with Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. 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 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. The Company recognizes revenue for fixed-fee advertising arrangements ratably over the term of the insertion order 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 recognizes revenue for the period by pro-rating the total arrangement fee to revenue and deferred revenue based on a measure of proportionate performance of its obligation under the insertion order. The Company measures proportionate performance by the number of placements delivered and undelivered as of the reporting date. The Company uses prices stated on its internal rate card for measuring the value of delivered and undelivered placements. Fees for 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. The Company considers an 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. The Company considers 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. The Company conducts a credit review for all transactions at the time of the arrangement to determine the creditworthiness of the client. Collection is deemed reasonably assured if it is expected that the client will be able to pay amounts under the arrangement as payments become due. If it is determined that collection is not reasonably assured, then revenue is deferred and recognized 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.

The Company s standard payment terms are 30 days net. Insertion orders that include fixed-fee advertising are invoiced upon acceptance of the insertion order and on the first day of each month over the term of the insertion order, with the exception of *Travelzoo Top 20* or *Newsflash* insertions, which are invoiced upon delivery. Insertion orders that include variable-fee advertising are invoiced at the end of the month. The Company s 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 client 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 from advertising sold to clients through agencies are reported at the net amount billed to the agency.

Note 3: Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payments (SFAS 123R), which addresses the accounting for stock-based payment transactions whereby an entity receives employee services in exchange for equity instruments, including stock options. SFAS 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and instead generally requires that such transactions be accounted for using a fair-value based method. The Company has elected the modified prospective transition method as permitted under SFAS 123R, and

Table of Contents

accordingly prior periods have not been restated to reflect the impact of SFAS 123R. The modified prospective transition method requires that stock-based compensation expense be recorded for all new and unvested stock options that are ultimately expected to vest as the requisite service is rendered beginning on January 1, 2006. Stock-based compensation for awards granted prior to January 1, 2006 is based upon the grant-date fair value of such compensation as determined under the pro forma provisions of SFAS No. 123, Accounting for Stock-Based Compensation.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Condensed Consolidated Statements of Cash Flows. SFAS 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be reclassified as financing cash flows. In the nine months ended September 30, 2006, no excess tax benefit was recorded.

As described in Note 1, as part of the consideration exchanged for the outstanding shares of Silicon Channels Corporation, the Company also issued to the majority stockholder in January 2001 fully vested and exercisable options to acquire 2,158,349 shares of common stock. The options have an exercise price of $1.00 per share, are outstanding as of September 30, 2006, and expire in January 2011.

In October 2001, the Company granted to each director fully vested and exercisable options to purchase 30,000 shares of common stock with an exercise price of $2.00 per share for their services as a director in 2000 and 2001. A total of 210,000 options were granted. The options expire in October 2011. 150,000 options and 17,275 options were exercised during the years ended December 31, 2004 and 2005, respectively. As of September 30, 2006, 42,725 options are vested and remain outstanding.

In March 2002, Travelzoo Inc. granted to each director options to purchase 5,000 shares of common stock with an exercise price of $3.00 per share that vested in connection with their services as a director in 2002. A total of 35,000 options were granted. In October 2002, 1,411 options were cancelled upon the resignation of a director. The options expire in March 2012. 23,589 of these options were exercised during the year ended December 31, 2004. As of September 30, 2006, 10,000 options are vested and remain outstanding.

The Company did not provide any stock-based compensation in fiscal years 2004, 2005, or in the nine months ended September 30, 2006. In addition, all previously issued options vested prior to January 1, 2002.

Option activity as of September 30, 2006 and changes during the nine months ended September 30, 2006 were as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	2,211,074	$ 1.03		
Outstanding at September 30, 2006	2,211,074	$ 1.03	4.36 years	$ 61,449
Exercisable and fully vested at September 30, 2006	2,211,074	$ 1.03	4.36 years	$ 61,449

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company s closing stock price on the last trading day of the third quarter of fiscal 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2006. This amount changes based on the fair market value of the Company s stock. The Company s policy is to issue shares from the authorized shares to fulfill stock option exercises.

Note 4: Net Income Per Share

Net income per share has been calculated in accordance with SFAS No. 128, Earnings per Share. Basic net income per share is computed using the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed by adjusting the weighted-average number of common shares outstanding for the effect of 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 per share (in thousands, except per share amounts):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Basic net income per share:				
Net income	$ 4,551	$ 2,298	$ 12,518	$ 6,309
Weighted average common shares	15,250	16,250	15,595	16,249
Basic net income per share	$ 0.30	$ 0.14	$ 0.80	$ 0.39
Diluted net income per share:				
Net income	$ 4,551	$ 2,298	$ 12,518	$ 6,309
Weighted average common shares	15,250	16,250	15,595	16,249
Effect of dilutive securities: stock options	1,214	1,445	1,208	1,648
Diluted weighted average common shares	16,464	17,695	16,803	17,897
Diluted net income per share	$ 0.28	$ 0.13	$ 0.74	$ 0.35

Note 5: Stockholders Equity

Share Repurchases

In February 2006, Travelzoo announced a share repurchase program authorizing the repurchase of up to 1.0 million shares of common stock in the open market or in private transactions. During the nine months ended September 30, 2006, the Company purchased and retired 1.0 million shares of common stock for an aggregate price of $28.6 million and completed the share repurchase under this program. There were no shares repurchased during the nine months ended September 30, 2005.

Note 6: Commitments and Contingencies

The Company leases office space in Canada, Germany, Spain, U.K., and U.S. under operating leases which expire between April 30, 2007 and December 31, 2009. The future minimum lease payments under these operating leases as of September 30, 2006 total $2,445,000. The future lease payments consist of $472,000 due in 2006, $1,699,000 due in 2007, $232,000 due in 2008, and $42,000 due in 2009.

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 being required to issue up to an additional approximately 4,074,000 shares of common stock for no additional payment.

On October 15, 2004, the Company announced a program under which it would 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 consolidated financial statements included a charge in general and administrative expenses of $124,000 for these cash payments for the nine months ended September 30, 2006 of which $5,000 remains as a liability as of September 30, 2006. The liability is based on the number of actual requests received from former stockholders through the reporting date which had not yet been processed. 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. 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 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. 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. Assuming 100% of the requests from 1998 were valid, former stockholders of Travelzoo.com Corporation holding approximately 4,074,000 shares had not submitted claims under the program.

Note 7: Segment Reporting and Significant Customer Information

The Company manages its business geographically and has two operating segments: North America and Europe. North America consists of the Company s operations in the U.S. and Canada. Europe consists of the Company s operations in the U.K., Germany, and Spain. The Company began operations in Europe in May 2005.

Table of Contents

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 and assets (in thousands) by business segment:

Three months ended September 30, 2006:	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$ 16,627	$ 959	$	$ 17,586
Intersegment revenues	37	4	(41)	
Total net revenues	16,664	963	(41)	$ 17,586
Operating income (loss)	8,406	(276)	1	8,131

Three months ended September 30, 2005:	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$ 13,017	$ 367	$	$ 13,384
Intersegment revenues	64	1	(65)	
Total net revenues	13,081	368	(65)	13,384
Operating income (loss)	4,556	(363)	(13)	4,180

Nine months ended September 30, 2006:	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$ 49,607	$ 2,266	$	$ 51,873
Intersegment revenues	150	6	(156)	
Total net revenues	49,757	2,272	(156)	51,873
Operating income (loss)	23,311	(1,230)	1	22,082

Nine months ended September 30, 2005:	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	$ 36,494	$ 377	$	$ 36,871
Intersegment revenues	79	1	(80)	
Total net revenues	36,573	378	(80)	36,871
Operating income (loss)	11,896	(537)	(13)	11,346

As of September 30, 2006	North America	Europe	Elimination	Consolidated
Property and equipment, net:	$ 126	$ 48	$	$ 174
Total assets	40,616	1,946	(3,644)	38,918

As of December 31, 2005		Europe	Elimination	Consolidated

	North America			
Property and equipment, net:	$ 139	$ 20	$	$ 159
Total assets	56,191	748	(1,487)	55,452

Revenue for each segment is recognized from the locations within a designated geographic region in accordance with SAB104. Property and equipment are attributed to the geographic region in which the assets are located.

11

Table of Contents

Significant customer information is as follows:

Customer	Percent of Revenues Three Months Ended September 30, 2006	Percent of Revenues Three Months Ended September 30, 2005	Percent of Revenues Nine Months Ended September 30, 2006	Percent of Revenues Nine Months Ended September 30, 2005	Percent of Accounts Receivable September 30, 2006	Percent of Accounts Receivable December 31, 2005
Travelport Limited	17%	*	16%	12%	23%	15%
Expedia, Inc.	15%	10%	14%	*	20%	*
Sabre Holdings Corporation	*	12%	*	16%	*	13%

* Less than 10%

The agreements with these customers are in the form of multiple insertion orders from groups of entities under common control, in either the Company s standard form or in the customer s form.

Note 8: Comprehensive Income

Comprehensive income consists of two components: net income and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that under generally accepted accounting principles are recorded as an element of stockholders equity but are excluded from net income. The Company s other comprehensive income (loss) is comprised of foreign currency translation adjustments.

Note 9: Foreign Currency

Realized gains and losses from foreign currency transactions are recognized as gain or loss on foreign currency. The Company does not use any derivatives for hedging or speculative purposes.

Note 10: Recent Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the effect the adoption of FIN 48 will have on its consolidated results of operations and financial condition and is not yet in a position to determine such effects. The Company will adopt FIN 48 in the first quarter of 2007.

In September 2006, the SEC issued SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 requires that registrants quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in a misstated amount that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the Company in the fourth quarter of 2006 and is not expected to have a material impact on the Company s consolidated financial statements.

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 , potential , continue , strategy , believes , anticipates , plans , expects , int 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.

Overview

Travelzoo is an Internet media company. We publish travel offers from hundreds of travel companies. 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 sales and specials from hundreds of travel companies.

Our publications include the *Travelzoo* Web sites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, and www.travelzoo.de), 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 500 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 sites, in the *Travelzoo Top 20* e-mail newsletter, in the *Newsflash* e-mail product, and in *SuperSearch*, a pay-per-click travel search engine. Revenues are principally generated from the sale of advertising in the U.S. Listing fees are based on placement, number of listings, number of impressions, or number of clickthroughs. Smaller advertising agreements typically $4,000 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.

We have two operating segments based on geographic regions: North America and Europe. North America consists of our operations in the U.S. and Canada. Europe consists of our operations in the U.K., Germany, and Spain.

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 newsletters and page views of the homepages of the *Travelzoo* Web sites;

- Growth in revenues in the absolute and relative to the growth in reach of the Company s publications;

- Operating margin; 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, the allowance for doubtful accounts, and liabilities to former stockholders. These policies, and our procedures related to these policies, are described in detail below.

13

Table of Contents

Revenue Recognition

We recognize revenue on arrangements in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, 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. 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 recognizes revenue for the period by pro-rating the total arrangement fee to revenue and deferred revenue based on a measure of proportionate performance of its obligation under the insertion order. The Company measures proportionate performance by the number of placements delivered and undelivered as of the reporting date. The Company uses prices stated on its internal rate card for measuring the value of delivered and undelivered placements. Fees for 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 reasonably assured. The Company evaluates each of these criteria as follows:

Evidence of an arrangement. We consider an 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 clickthroughs 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 and payment terms are standard.

Collection is reasonably assured. We conduct a credit review for all 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.

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.

Liability to Former Stockholders

On October 15, 2004, we announced a program under which we would 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. We account for the cost of this program as an expense recorded in general and administrative expenses. The ultimate 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. 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. We do not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid. We believe that only a portion of such requests were valid. 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

Since the total cost of the program is not reliably estimable, the amount of expense recorded in a period is equal to the number of actual claims received during the period multiplied by (i) the number of shares held by each individual former stockholder and (ii) the applicable settlement price based on the recent price of our common stock at the date the claim is received as stipulated by the program. Requests are generally paid within 30 days of receipt. Please refer to Note 6 to our unaudited condensed consolidated financial statements for further details about our liabilities to former stockholders.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues	100%	100%	100%	100%
Cost of revenues	1	2	1	2
Gross profit	99	98	99	98
Operating expenses:				
Sales and marketing	40	53	43	49
General and administrative	13	14	13	18
Total operating expenses	53	67	56	67
Income from operations	46	31	43	31
Other income and expenses, net	2	2	1	2
Income before income taxes	48	33	44	33
Income taxes	22	16	20	16
Net income	26%	17%	24%	17%

For the nine months ended September 30, 2006, we reported income from operations of approximately $22.1 million. As of September 30, 2006, we had retained earnings of approximately $30.3 million. Our operating margin increased to 42.6% of sales for the nine months ended September 30, 2006 from 30.8% for the same period last year. The main reason for this increase in our operating margin is that our sales and marketing expenses as a percentage of revenue did not increase at the same rate as our revenues due primarily to a decrease in marketing expenses as a result of a lower average cost of acquiring new subscribers (see Subscriber Acquisition below). Another reason for this increase in our operating margin is that our general and administrative expenses as a percentage of revenue did not increase at the same rate as our revenues due primarily to a decrease in the number of requests received 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.

We do not know whether our sales and marketing expenses as a percentage of revenue will continue to decrease in future periods. Increased competition in our industry may require us to do more advertising for our brand and for our products. Increases in the average cost of acquiring new subscribers (see Subscriber Acquisition below) may result in an increase of sales and marketing expenses as a percentage of revenue. 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, our strategy to replicate our business model in selected foreign markets (see Growth Strategy below) may result in a significant increase in our sales and marketing expenses and have a material adverse impact on our results of operations. We expect fluctuations of sales and marketing expenses as a percentage of revenue 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. In addition, we expect that we will incur significant expenses in 2006 in order to allow management to report on, and our independent auditors to attest to, our internal controls over financial reporting, as required by Section 404 for the Sarbanes-Oxley Act of 2002 (SOX). At this time, the total cost is not reliably estimable as it will be dependent on the number of areas requiring improvement and the extent of any required remediation efforts as well as growth of our international operations. We expect our planned 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 former stockholders of Travelzoo.com Corporation, who failed to submit requests for shares in Travelzoo Inc. within the required time period.

The increase in other income from approximately $648,000 in the nine months ended September 30, 2005 to approximately $938,000 in the nine months ended September 30, 2006 is primarily due to increased interest earned on the Company s cash, cash equivalents, and short-term investments as a result of an increase in the average interest rate.

Table of Contents

Reach

The following table sets forth the number of subscribers of each of our e-mail publications in both North America and Europe as of September 30, 2006 and 2005, the total number of page views for the homepages of the *Travelzoo* Web sites in North America for the nine months ended September 30, 2006 and 2005, and the total number of page views for the homepages of the *Travelzoo* Web sites in Europe for the nine months ended September 30, 2006. Management considers the page views for the *Travelzoo* homepages as indicators for the growth of Web site traffic. Management reviews these non-financial metrics for two reasons: First, to monitor our progress in increasing the reach of our products. Second, to evaluate whether we are able to convert higher reach into higher revenues.

	September 30,		**Year-over-Year**
	2006	**2005**	**Growth**
Subscribers:			
North America			
Travelzoo Top 20	9,691,000	8,660,000	12%
Newsflash	7,408,000	5,780,000	28%
Europe			
Travelzoo Top 20	588,000	140,000	320%
Newsflash	504,000	70,000	620%

	Nine Months Ended September 30,		**Year-over-Year**
	2006	**2005**	**Growth***
Page views of homepages of *Travelzoo* Web sites:			
North America	32,443,000	29,888,000	9%
Europe	2,545,000	N/A	N/A

* The comparability of year-over-year changes of page views of the homepages of *Travelzoo* Web sites may be limited due to the design and navigation of the Web sites. Additionally, we believe that the increased use of security software has adversely affected the tracking of page views.

The Company s revenues for North America for the nine months ended September 30, 2006 increased by 36% from the same period last year. The number of subscribers of the *Travelzoo Top 20* e-mail newsletter increased by 12% for

North America and page views of the homepages of the *Travelzoo* North America Web sites increased by 9% as shown in the table above. Management believes that the data for the nine months ended September 30, 2006 and 2005 indicate that the Company was able to generate higher revenues as total reach increased.

Revenues

Our total revenues increased to $17.6 million for the three months ended September 30, 2006 from $13.4 million for the three months ended September 30, 2005. This represents an increase of 31%. Our total revenues increased to $51.9 million for the nine months ended September 30, 2006 from $36.9 million for the nine months ended September 30, 2005. This represents an increase of 41%.

14% of our revenue growth in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 came from our operations in Europe. The remaining 86% came from our operations in North America (i.e. *Travelzoo* Web sites, *Travelzoo Top 20* newsletter, *Newsflash* and *SuperSearch*) and is attributed to an increase in our advertising rates for our existing products and an increase in the number of clients and the volume of advertising sold. Approximately 27% of our revenue growth in the three month period ended September 30, 2006 compared to the three months ended September 30, 2005 is attributed to an increase in our advertising rates for our existing products. Due to the increase in the reach of our publications, we increased the prices for advertising placements in our publications on average by approximately 13% as of January 1, 2006. Approximately 59% of our revenue growth in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 is attributed to an increase in the number of clients and an increase in the volume of advertising sold to existing clients.

13% of our revenue growth in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 came from our operations in Europe. The remaining 87% came from our operations in North America (i.e. *Travelzoo* Web sites, *Travelzoo Top 20* newsletter, *Newsflash* and *SuperSearch*) and is attributed to an increase in our advertising rates for our existing products and an increase in the number of clients and the volume of advertising sold. Approximately 22% of our revenue growth in the nine month period ended September 30, 2006 compared to the nine months ended September 30, 2005 is attributed to an increase in our advertising rates for our existing products. Due to the increase in the reach of our publications, we increased the prices for advertising placements in our publications on average by approximately 13% as of January 1, 2006. Approximately 65% of our revenue growth in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 is attributed to an increase in the number of clients and an increase in the volume of advertising sold to existing clients.

Table of Contents

As discussed in Note 7 in the notes to the condensed financial statements, two clients each accounted for 10% or more of our total revenues during the three and nine months ended September 30, 2006 and September 30, 2005. No other clients accounted for 10% or more of our total revenues during the three and nine months ended September 30, 2006 and 2005. The agreements with these clients are in the form of multiple insertion orders from groups of entities under common control. Management expects revenue concentration to remain at the current level in the foreseeable future because there is a high concentration in the online travel agency industry.

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 clients; and
- Our ability to increase the number of clients.

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. 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 have increased the number of clients in every year since inception. We do not know if we will be able to increase the number of clients in the future.

Over the last three years we increased advertising rates as of January 1 of each year. We intend to increase advertising rates once a year as of January 1. However, there is no assurance that there will be increases of advertising rates. Depending on the level of competition in the industry and the condition of the online advertising market, we may decide not to increase our advertising rates.

Our revenue growth in North America slowed down in the second quarter of 2006 and in the third quarter of 2006. We do not know if this is a trend. We do not know if we are able to further grow revenue of our North America segment.

Average annualized revenue per employee increased to $868,000 for the three months ended September 30, 2006 from $824,000 for the three months ended September 30, 2005.

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 photos. Our cost of revenues increased to $232,000 for the three months ended September 30, 2006 from $225,000 for the three months ended September 30, 2005. Our cost of revenues increased to $782,000 for the nine months ended September 30, 2006 from $629,000 for the nine months ended September 30, 2005. As a percentage of revenue, cost of revenues remained the same, 2%, for the nine months ended September 30, 2006 and for the nine months ended September 30, 2005. The $7,000 increase in cost of revenues in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 was primarily due to an increase in salary expense associated with our network operations staff offset by a decrease in network expenses. The $153,000 increase in cost of revenues in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 was primarily due to an increase in salary expenses associated with our network operations staff.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of advertising and promotional expenses, salary expenses associated with sales and marketing staff, expenses related to our participation in industry conferences, and public relations expenses. Sales and marketing expenses decreased to $7.0 million for the three months ended September 30, 2006 from $7.1 million for the three months ended September 30, 2005. Sales and marketing expenses increased to $22.0 million for the nine months ended September 30, 2006 from $18.3 million for the nine months ended September 30, 2005. The goal of our advertising was to acquire new subscribers for our e-mail products and to increase brand awareness for *Travelzoo* and consists primarily of online advertising. The $127,000 decrease in sales and marketing expenses in the three months ended September 30, 2006 compared to the three months ended

September 30, 2005 was primarily due a $1.5 million decrease in advertising to acquire new subscribers for our e-mail products, offset by a $823,000 increase in advertising expenses for promotional and brand awareness campaign and $541,000 of increased expenses due to an increase in the headcount of our sales force. For the three months ended September 30, 2006 and 2005, advertising expenses accounted for 70% and 80%, respectively, of sales and marketing expenses. The $3.8 million increase in sales and marketing expenses in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 was primarily due to increases in our advertising campaigns. For the nine months ended September 30, 2006 and 2005, advertising expenses accounted for 70% and 78%, respectively, of sales and marketing expenses. The increase in sales and marketing expenses in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 was also due to an increase in headcount of our sales force.

Our goal is to increase our revenues from advertising sales. One important factor that drives our revenues is 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 and continue to promote our brand. 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.

Table of Contents

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 $2.2 million for the three months ended September 30, 2006 from $1.9 million for the three months ended September 30, 2005. General and administrative expenses increased to $7.0 million, for the nine months ended September 30, 2006 from $6.6 million for the nine months ended September 30, 2005.

In the three months ended September 30, 2006 and 2005, the Company recorded expenses of $39,000 and $64,000, respectively, and in the nine months ended September 30, 2006 and 2005, the Company recorded expenses of $124,000 and $1.2 million, respectively, related to a program under which the Company makes 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 expenses are based on the number of actual valid claims received and the Company s stock price. The Company cannot reliably estimate future expenses incurred under this program because it is based on the number of valid requests received and future levels of the Company s common stock price.

Audit fees and third-party SOX compliance costs were approximately $353,000 and $194,000, respectively, in the three months ended September 30, 2006 and September 30, 2005, and were approximately $1.0 million and $676,000, respectively, in the nine months ended September 30, 2006 and September 30, 2005.

The increase in general and administrative expenses in the three months ended September 30, 2006 compared to the three months ended September 30, 2005 was also due to a $149,000 increase in office expenses. The increase in general and administrative expenses in the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 was also due to a $491,000 increase in office expenses, a $198,000 increase in legal and professional services and a $128,000 increase in bad debt expense.

Subscriber Acquisition

The table set forth below provides for each quarter in 2003, 2004, 2005, and the first nine months of 2006, an analysis of our average cost for acquisition of new subscribers for our *Travelzoo Top 20* newsletter and our *Newsflash* e-mail alert service for our operating segments, North America and Europe.

The table includes the following data:

Average Cost per Acquisition of a New Subscriber: This is the quarterly costs of consumer marketing programs whose purpose was primarily to acquire new subscribers, divided by total new subscribers added during the quarter.

New Subscribers: Total new subscribers who signed up for at least one of our e-mail publications throughout the quarter. This is an unduplicated subscriber number, meaning a subscriber who signed up for two or more of our publications is only counted once.

Unsubscribes: Subscribers who were removed from our list throughout the quarter either as a result of their requesting removal, or based on periodic list maintenance after we determined that the e-mail address was likely no longer valid.

Table of Contents

Balance: This is the number of subscribers at the end of the quarter, computed by taking the previous quarter s subscriber balance, adding new subscribers during the current quarter, and subtracting unsubscribes during the current quarter.

North America:

Period	Average Cost per Acquisition of a New Subscriber	New Subscribers	Unsubscribes	Balance
Q1 2003	$ 1.62	693,872	(213,423)	3,962,625
Q2 2003	$ 1.58	924,902	(172,403)	4,715,124
Q3 2003	$ 1.52	1,108,045	(248,964)	5,574,205
Q4 2003	$ 2.17	869,286	(240,907)	6,202,584
Q1 2004	$ 2.23	920,063	(185,151)	6,937,496
Q2 2004	$ 2.58	858,899	(634,702)	7,161,693
Q3 2004	$ 1.26	1,298,962	(602,628)	7,858,027
Q4 2004	$ 1.70	694,026	(406,316)	8,145,737
Q1 2005	$ 2.59	659,459	(475,938)	8,329,258
Q2 2005	$ 2.62	806,734	(533,109)	8,602,883
Q3 2005	$ 3.19	740,768	(422,868)	8,920,783
Q4 2005	$ 2.41	729,460	(273,389)	9,376,854
Q1 2006	$ 2.54	714,643	(317,947)	9,773,550
Q2 2006	$ 2.11	737,735	(532,676)	9,978,609
Q3 2006	$ 1.86	491,524	(327,471)	10,142,662

Europe:

Period	Average Cost per Acquisition of a New Subscriber	New Subscribers	Unsubscribes	Balance
Q3 2005	$ 1.65	127,857	(5,577)	140,153
Q4 2005	$ 2.02	174,514	(16,898)	297,769
Q1 2006	$ 2.15	143,666	(16,831)	424,604
Q2 2006	$ 2.69	129,438	(34,070)	519,972
Q3 2006	$ 1.23	126,566	(29,794)	616,744

In North America, we have noted a trend of increasing average cost per new subscriber over the last few years, driven by a gradual increase in online advertising rates by our media suppliers as well as increased activity from competitors using similar forms of online advertising for their own marketing efforts. The decline in new subscriber acquisition costs in North America in Q3 2004 reflects the effect of new advertising campaigns which were tested at that time. The decline in new subscriber acquisition costs in North America in Q3 2006 was impacted by a credit received from a vendor in the amount of $170,000. We do not consider the decline in new subscriber costs to be indicative of a longer-term trend, or to indicate that our subscriber costs are likely to stay at this level or are likely to decline further.

Increasing average cost per suscriber is likely to result in higher absolute marketing expenses and potentially higher relative marketing expenses as a percentage of revenue. Going forward we expect continued upward pressure on online advertising rates and continued activity from competitors, which will likely increase our cost per new subscriber over the long term. The effect on operations my be that greater absolute and relative marketing expenditure is necessary to continue to grow the reach of our publications. However, it is possible that the factors driving subscriber acquisition cost increases can be partially or completely offset by new or improved methods of subscriber acquisition using techniques which are under evaluation.

Table of Contents

Segment Information

We have presented the business segments in this Form 10-Q based on our organizational structure as of September 30, 2006.

North America

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	**2005**	**% Change**	**2006**	**2005**	**% Change**
	(In thousands)			(In thousands)		
Net revenues	$16,664	$13,081	27%	$49,757	$36,573	36%
Income from operations	8,406	4,556	85%	23,311	11,896	96%
Income from operations as a % of revenues	50%	35%	45%	47%	33%	44%

In North America, revenues increased 36% in the first nine months of 2006 compared to the same period in 2005. The North America revenue growth was driven by the increase of advertising rates, additions of new clients and increased spending from existing clients.

Income from operations for North America as a percentage of revenue in the nine months ended September 30, 2006 increased by 14 percentage points. This was primarily due to a 9 percentage point decrease in sales and marketing expenses as a percentage of revenue in the nine months ended September 30, 2006 compared to the same period last year. Sales and marketing expenses for North America increased to $19.9 million in the nine months ended September 30, 2006 compared to $17.9 million in the same period last year. This $2.0 million increase was primarily due to a $963,000 increase in salary expenses resulting mostly from an increase in headcount and a $596,000 increase for our advertising campaigns. There was also a 5 percentage point decrease in general and administrative expenses as a percentage of revenue in the nine months ended September 30, 2006 compared to the same period last year. General and administrative expenses for North America decreased to $5.8 million in the nine months ended September 30, 2006 compared to $6.1 million in the same period last year. This $300,000 decrease was primarily due to a $1.1 million decrease in expenses related to a program under which the Company makes cash payments to people who establish they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into Travelzoo Inc. within the required time period, offset by a $229,000 increase in additional office expenses and a $350,000 increase in audit and SOX compliance fees.

Europe

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2006	**2005**	**% Change**	**2006**	**2005**	**% Change**
	(In thousands)			(In thousands)		
Net revenues	$ 963	$ 368	162%	$ 2,272	$ 378	501%
Loss from operations	(276)	(363)	-24%	(1,230)	(537)	129%
Loss from operations as a % of revenues	29%	99%	-71%	54%	142%	-62%

In Europe, revenues increased $1.9 million in the first nine months of 2006 compared to the same period in 2005. We began operations in Europe in May 2005.

Our loss from operations in Europe was $1.2 million in the nine months ended September 30, 2006 compared to $537,000 in the nine months ended September 30, 2005. This was primarily due to increased sales and marketing expenses related to the acquisition of subscribers and Web site traffic and increased salary expense due to an increase in headcount.

Income Taxes

We recorded income tax provisions of $3.9 million and $2.2 million for the three months ended September 30, 2006 and September 30, 2005, respectively. We recorded income tax provisions of $10.5 million and $5.7 million for the nine months ended September 30, 2006 and September 30, 2005, respectively. 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 and expenses, adjusted to take into account expenses that are treated as having no recognizable tax benefit. For the nine months ended September 30, 2006, our effective tax rate was 45.6%. Expenses of $124,000 related to a program under which the Company makes cash payments to former stockholders of Travelzoo.com Corporation, who failed to submit requests for shares in Travelzoo Inc. within the required time period, were treated as having no recognizable tax benefit. Further, a loss of $1.2 million from our operations in Europe was treated as having no recognizable tax benefit.

We expect that our effective tax rate in future periods may fluctuate depending on the total amount of expenses representing payments to former stockholders, from losses or gains incurred by our European operations and Canadian operations, related European and Canadian tax liabilities and corresponding U.S. tax credits, if any.

During the nine months ended September 30, 2005, the Company realized a tax benefit of $396,000 upon the exercise of stock options by a director. The tax benefit reduced the Company s income tax payable and increased additional paid-in capital by this amount.

Liquidity and Capital Resources

As of September 30, 2006, we had $28.0 million in cash and cash equivalents and short-term investments. Cash and cash equivalents and short-term investments decreased from $44.4 million on December 31, 2005 primarily as a result of cash used in financing activities as explained below. 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, 2006 was $11.8 million. Net cash provided by operating activities in the nine months ended September 30, 2005 was $6.2 million. In the nine months ended September 30, 2006, net cash provided by operating activities resulted primarily from net income offset by a decrease in income tax payable and a decrease in accrued interest income. In the nine months ended September 30, 2005, 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 provided by investing activities was $20.2 million in the nine months ended September 30, 2006. Net cash used in investing activities was $9.7 million during the nine months ended September 30, 2005. In the nine months ended September 30, 2006, net cash provided by investing activities was primarily from the sale of short-term investments offset by the purchase of short-term investments. In the nine months ended September 30, 2005, net cash used in investing activities was primarily for the purchase of short-term investments offset by the sale of short-term investments.

Net cash used in financing activities was $28.6 million during the nine months ended September 30, 2006. Net cash used in financing activities was $89,000 during the nine months ended September 30, 2005. In the nine months ended September 30, 2006, net cash used in financing activities resulted from the repurchase of common stock by the Company. In the nine months ended September 30, 2005, net cash used in financing activities resulted primarily from related costs from the issuance of common stock in 2004.

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 development and launch of new products, cash payments to former stockholders of Travelzoo.com Corporation, expansion of our operations, and the amount of our resources we devote to promoting awareness of the *Travelzoo* brand. Since the inception of the program under which we would make cash payments to persons who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests for our shares within the required time period, we have incurred expenses of $2.5 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 claims ultimately received. 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.

Although we currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements beyond the next 12 months, unanticipated events and opportunities 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.

We expect that cash on hand will be sufficient to finance the growth of our European operations.

The following summarizes our principal contractual commitments as of September 30, 2006 (in thousands):

	2006	2007	2008	2009	Thereafter	Total
Operating leases	$ 472	$ 1,699	$ 232	$ 42	$	$ 2,445
Purchase obligations	28	8				36
Total commitments	$ 500	$ 1,707	$ 232	$ 42	$	$ 2,481

Growth Strategy

Our growth strategy has two main elements:

Replicate our business model in selected foreign markets in Europe and in the Asia Pacific region; and

Expand the scope of our business model.

We intend to begin operations in France in 2007. We intend to create a third business segment, Asia Pacific, and begin operations in the Asia Pacific region, including Australia, Greater China (China, Hong Kong, Taiwan), India, Japan, and South Korea, in 2007 and 2008.

In North America, we recently launched *Travelzoo Extra*, a new section on our U.S. Web site that promotes non-travel deals. Further, we are currently evaluating listing show ticket offers on our Web sites. Further, we intend to launch Travelzoo Network, a network of affiliate Web sites that list travel deals published by Travelzoo.

We do not know what impact this growth strategy will have on our results of operations because we cannot reliably estimate expenses and revenues. It is possible that the increase in expenses will have a material adverse impact on our results of operations.

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 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 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 travel companies. 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. If our operations in Europe and our expected expansion into other regions in the future incur significant losses, this will result in a significant negative impact on our results of operations. 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: