Expedia, Inc.
Form 10-Q
November 14, 2006

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

Form 10-Q

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 Number: 000-51447

EXPEDIA, INC.
(Exact name of registrant as specified in its charter)

Delaware	**20-2705720**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

3150 139th Avenue SE
Bellevue, WA 98005
(Address of principal executive office) (Zip Code)
(425) 679-7200
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes o No þ

The number of shares outstanding of each of the registrant s classes of common stock as of October 31, 2006 was:

Common stock, $0.001 par value per share	305,520,821 shares
Class B common stock, $0.001 par value per share	25,599,998 shares

EXPEDIA, INC.

Form 10-Q

For the Quarter Ended September 30, 2006

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Part I. Item 1. Consolidated Financial Statements

EXPEDIA, INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue	$ 613,942	$ 584,653	$ 1,706,298	$ 1,624,706
Cost of revenue(1)	133,094	124,020	380,857	367,607
Gross profit	480,848	460,633	1,325,441	1,257,099
Operating expenses:				
Selling and marketing(1)	215,086	184,560	614,778	556,763
General and administrative(1)	66,156	60,686	210,570	183,736
Technology and content(1)	36,034	30,854	104,866	101,998
Amortization of intangible assets	26,569	30,756	86,860	94,204
Impairment of intangible asset	47,000		47,000	
Amortization of non-cash distribution and marketing	711	5,138	9,578	9,055
Operating income	89,292	148,639	251,789	311,343
Other income (expense):				
Interest income from IAC/InterActiveCorp		15,316		40,089
Other interest income	9,697	2,962	20,332	7,774
Interest expense	(4,857)	(310)	(7,230)	(384)
Write-off of long-term investment		(23,426)		(23,426)
Other, net	2,926	7,379	17,049	11,889
Total other income, net	7,766	1,921	30,151	35,942
Income before income taxes and minority interest	97,058	150,560	281,940	347,285
Provision for income taxes	(37,707)	(69,026)	(103,523)	(143,895)
Minority interest in (earnings) losses of consolidated subsidiaries, net	(374)	501	(623)	106
Net income	$ 58,977	$ 82,035	$ 177,794	$ 203,496
Net earnings per share available to common stockholders:				
Basic	$ 0.18	$ 0.24	$ 0.52	$ 0.61
Diluted	0.17	0.23	0.50	0.59
Shares used in computing earnings per share:				
Basic	330,359	336,409	340,660	335,833
Diluted	341,137	353,351	355,075	344,819

(1) Includes stock-based compensation as follows:				
Cost of revenue	$ 1,816	$ (4,052)	$ 6,627	$ 7,133
Selling and marketing	2,968	(861)	11,665	14,590
General and administrative	7,043	1,791	25,483	37,527
Technology and content	4,612	2,113	13,772	20,649
Total stock-based compensation	$ 16,439	$ (1,009)	$ 57,547	$ 79,899

See accompanying notes.

EXPEDIA, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 945,692	$ 297,416
Restricted cash and cash equivalents	18,274	23,585
Accounts and notes receivable, net of allowance of $4,365 and $3,914	216,947	174,019
Prepaid merchant bookings	53,040	30,655
Prepaid expenses and other current assets	62,002	64,569
Total current assets	1,295,955	590,244
Property and equipment, net	124,737	90,984
Long-term investments and other assets	56,113	39,431
Intangible assets, net	1,050,764	1,176,503
Goodwill	5,856,663	5,859,730
TOTAL ASSETS	$ 8,384,232	$ 7,756,892
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable, merchant	$ 658,452	$ 534,882
Accounts payable, other	126,934	107,580
Short-term borrowings	256	230,755
Deferred merchant bookings	623,944	406,948
Deferred revenue	11,083	7,068
Income taxes payable	80,396	43,405
Deferred income taxes, net	103	3,178
Other current liabilities	125,946	104,409
Total current liabilities	1,627,114	1,438,225
Long-term debt	500,000	
Deferred income taxes, net	341,433	368,880
Derivative liabilities	30,845	105,827
Other long-term liabilities	34,427	38,423
Minority interest	55,960	71,774
Commitments and contingencies		
Stockholders equity:		
Preferred stock $.001 par value		
Authorized shares: 100,000,000		
Series A shares issued and outstanding: 846 and 846		
Common stock $.001 par value	327	323
Authorized shares: 1,600,000,000		
Shares issued: 327,428,245 and 323,184,577		

Shares outstanding: 305,293,547 and 321,979,486		
Class B common stock $.001 par value	26	26
Authorized shares: 400,000,000		
Shares issued and outstanding: 25,599,998 and 25,599,998		
Additional paid-in capital	5,865,119	5,695,498
Treasury stock Common stock, at cost	(320,569)	(25,464)
Shares: 22,134,698 and 1,205,091		
Retained earnings	242,772	64,978
Accumulated other comprehensive income (loss)	6,778	(1,598)
Total stockholders equity	5,794,453	5,733,763
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 8,384,232	$ 7,756,892

See accompanying notes.

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EXPEDIA, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
AND COMPREHENSIVE INCOME (LOSS)
(in thousands, except share data)
(Unaudited)

	Preferred stock		Common stock		Class B common stock		Additional paid-in capital	Treasury stock	Retained earnings	Accumulated other comprehensive income (loss)	Tot
	Shares	Amount	Shares	Amount	Shares	Amount	capital	stock	earnings	(loss)	
ce as of December 31,	846	$	323,184,577	$ 323	25,599,998	$ 26	$ 5,695,498	$ (25,464)	$ 64,978	$ (1,598)	$ 5,733
rehensive income:											
come									177,794		177
ss on derivative contracts										(1,097)	(1
ncy translation adjustment										9,473	9
comprehensive income											186
ment of derivative liability							71,584				71
eds from exercise of instruments			4,243,668	4			29,163				29
Off related tax adjustment							17,465				17
eficiencies on equity ls and other, net							(7,869)				(7
ury stock activity related rcise of equity ments								(6,777)			(6
non stock repurchases								(288,328)			(288
fication of cash-based awards							2,930				2
-based compensation se							56,348				56
ce as of September 30,	846	$	327,428,245	$ 327	25,599,998	$ 26	$ 5,865,119	$ (320,569)	$ 242,772	$ 6,778	$ 5,794

See accompanying notes.

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EXPEDIA, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Nine months ended September 30,	
	2006	**2005**
Operating activities:		
Net income	$ 177,794	$ 203,496
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	35,834	37,869
Amortization of intangible assets, non-cash distribution and marketing, and stock-based compensation	153,985	183,158
Deferred income taxes	(31,702)	29,948
Unrealized gain on derivative instruments, net	(11,609)	(12,000)
Equity in earnings of unconsolidated affiliates	(2,331)	(870)
Minority interest in earnings (losses) of consolidated subsidiaries, net	623	(106)
Write-off of long-term investment		23,426
Impairment of intangible asset	47,000	
Other	785	690
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts and notes receivable	(39,767)	(28,468)
Prepaid merchant bookings and prepaid expenses	(30,178)	(39,047)
Accounts payable, other and other current liabilities	103,189	133,105
Accounts payable, merchant	122,307	212,804
Deferred merchant bookings	216,911	197,154
Deferred revenue	4,001	2,494
Net cash provided by operating activities	746,842	943,653
Investing activities:		
Acquisitions, net of cash acquired	(29,830)	11,515
Capital expenditures	(67,580)	(40,859)
Increase in long-term investments and deposits	(1,820)	(2,379)
Transfers to IAC/InterActiveCorp, net		(753,613)
Other, net		(1,967)
Net cash used in investing activities	(99,230)	(787,303)
Financing activities:		
Repayment of short-term borrowings	(230,649)	
Proceeds from issuance of long-term debt, net of issuance costs	495,682	
Changes in restricted cash and cash equivalents	(2,604)	(23,173)
Proceeds from exercise of equity awards	29,360	20,458
Excess tax benefit on equity awards	781	
Treasury stock activity	(295,105)	
Distribution to IAC/InterActiveCorp, net		(65,991)
Other, net		(2,601)

Net cash used in financing activities	(2,535)	(71,307)
Effect of exchange rate changes on cash and cash equivalents	3,199	1,164
Net increase in cash and cash equivalents	648,276	86,207
Cash and cash equivalents at beginning of period	297,416	141,668
Cash and cash equivalents at end of period	$ 945,692	$ 227,875
Supplemental cash flow information		
Cash paid for interest	$ 2,859	$
Income tax payments, net	63,955	5,115

See accompanying notes.

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Notes to Consolidated Financial Statements
September 30, 2006
(Unaudited)

Note 1 Basis of Presentation

Description of Business

Expedia, Inc. and its subsidiaries provide travel products and services to leisure and corporate travelers in the United States (U.S.) and abroad. These travel products and services are offered through a diversified portfolio of brands including: Expedia, Hotels.com, Hotwire.com, our private label programs (Worldwide Travel Exchange and Interactive Affiliate Network), Classic Vacations, Expedia Corporate Travel (ECT), eLong and TripAdvisor. In addition, many of these brands have related international points of sale. We refer to Expedia, Inc. and its subsidiaries collectively as Expedia, the Company, us, we and our in these unaudited consolidated financial statements.

On December 21, 2004, IAC/InterActiveCorp (IAC) announced its plan to separate into two independent public companies to allow each company to focus on its individual strategic objectives. We refer to this transaction as the Spin-Off. A new company, Expedia, Inc., was incorporated under Delaware law in April 2005, to hold substantially all of IAC s travel and travel-related businesses. On August 9, 2005, the Spin-Off was completed and Expedia, Inc. shares began trading on NASDAQ under the symbol EXPE.

Basis of Presentation

These accompanying financial statements present our results of operations, financial position, stockholders equity and comprehensive income (loss), and cash flows on a combined basis through the Spin-Off on August 9, 2005, and on a consolidated basis thereafter. We have prepared the combined financial statements from the historical results of operations and historical bases of the assets and liabilities with the exception of income taxes. We have computed income taxes using our stand-alone tax rate. The unaudited consolidated financial statements include Expedia, Inc., our wholly-owned subsidiaries, and entities we control. We have eliminated significant intercompany transactions and accounts.

We believe that the assumptions underlying our unaudited consolidated financial statements are reasonable. However, these unaudited consolidated financial statements do not present our future financial position, the results of our future operations and cash flows, nor do they present what our historical financial position, results of operations and cash flows would have been prior to Spin-Off had we been a stand-alone company.

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial reporting. We have included all adjustments necessary for a fair presentation of the results of the interim period. These adjustments consist of normal recurring items. Our interim unaudited consolidated financial statements are not necessarily indicative of results that may be expected for any other interim period or for the full year. These interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2005, previously filed with the Securities and Exchange Commission (SEC).

Accounting Estimates

We use estimates and assumptions in the preparation of our interim unaudited consolidated financial statements in accordance with GAAP. Our estimates and assumptions affect the reported amounts of assets

Notes to Consolidated Financial Statements (Continued)

and liabilities and disclosure of contingent assets and liabilities as of the date of our interim unaudited consolidated financial statements. These estimates and assumptions also affect the reported amount of net income during any period. Our actual financial results could differ significantly from these estimates. The significant estimates underlying our interim unaudited consolidated financial statements include revenue recognition, accounting for merchant payables, recoverability of long-lived and intangible assets and goodwill, income taxes, occupancy tax, stock-based compensation and accounting for derivative instruments.

Reclassifications

We have reclassified prior period financial statements to conform to the current period presentation.

In our consolidated statements of income for the three and nine months ended September 30, 2005, we reclassified stock-based compensation expense to the same operating expense line items as cash compensation paid to employees in accordance with the SEC Staff Accounting Bulletin No. 107 (SAB 107).

In our consolidated statements of cash flows for the nine months ended September 30, 2005, we reclassified $13.1 million of transfers to IAC from financing activities to investing activities, and we reclassified $13.3 million of changes in restricted cash and cash equivalents to financing activities.

In our consolidated balance sheet as of December 31, 2005, we reclassified $19.7 million from accounts payable, other, to accounts payable, merchant ($19.3 million) and other current liabilities ($0.4 million).

Seasonality

We generally experience seasonal fluctuations in the demand for our travel products and services. For example, traditional leisure travel bookings are generally the highest in the first three quarters of the year as travelers plan and book their spring, summer and holiday travel. The number of bookings decreases in the fourth quarter. Because revenue in the merchant business is generally recognized when the travel takes place rather than when it is booked, revenue typically lags bookings by a month or longer. As a result, revenue is typically the lowest in the first quarter and highest in the third quarter.

Note 2 Summary of Significant Accounting Policies

Stock-Based Compensation

Effective January 1, 2006, we began accounting for stock-based compensation under the modified prospective method provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* (SFAS 123(R)), and related guidance. Under SFAS 123(R), we continue to measure and amortize the fair value for all share-based payments consistent with our past practice under SFAS 123, *Accounting for Stock-Based Compensation,* and SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. As a result, the adoption of SFAS 123(R) did not have a material impact on our financial position.

We measure and amortize the fair value of restricted stock units, stock options and warrants as follows:

Restricted Stock Units (RSU). RSUs are stock awards that are granted to employees entitling the holder to shares of common stock as the award vests, typically over a five-year period. We measure the value of RSUs at fair value based on the number of shares granted and the quoted price of our common stock at the date of grant. We amortize the fair value, net of estimated forfeitures, as stock-based compensation expense over the vesting term on a straight-line basis. We record RSUs that may be settled by the holder in cash, rather than shares, as a liability and we remeasure these instruments at fair value at the end of each reporting period.

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Notes to Consolidated Financial Statements (Continued)

Upon settlement of these awards, our total compensation expense recorded over the vesting period of the awards will equal the settlement amount, which is based on our stock price on the settlement date.

Performance-based RSUs vest upon achievement of certain company-based performance conditions. On the date of grant, we assess whether it is probable that the performance targets will be achieved, and if assessed as probable, we determine the fair value of the performance-based award based on the fair value of our common stock at that time. We record compensation expense for these awards over the estimated performance period using the accelerated method under Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an interpretation of Accounting Principles Board Opinion No. 15 and 25*. At each reporting period, we reassess the probability of achieving the performance targets and the performance period required to meet those targets. The estimation of whether the performance targets will be achieved and of the performance period required to achieve the targets requires judgment, and to the extent actual results or updated estimates differ from our current estimates, the cumulative effect on current and prior periods of those changes will be recorded in the period estimates are revised. The ultimate number of shares issued and the related compensation expense recognized will be based on a comparison of the final performance metrics to the specified targets.

Stock Options and Warrants. We measure the value of stock options and warrants issued or modified, including unvested options assumed in acquisitions, on the grant date (or modification or acquisition dates, if applicable) at fair value, using the Black-Scholes option valuation model. We amortize the fair value, net of estimated forfeitures, over the remaining vesting term on a straight-line basis.

Estimates of fair value are not intended to predict actual future events or the value ultimately realized by employees who receive these awards, and subsequent events are not indicative of the reasonableness of our original estimates of fair value. In determining the estimated forfeiture rates for stock-based awards, we periodically conduct an assessment of the actual number of equity awards that have been forfeited to date as well as those expected to be forfeited in the future. We consider many factors when estimating expected forfeitures, including the type of award, the employee class and historical experience. The estimate of stock awards that will ultimately be forfeited requires significant judgment and to the extent that actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period such estimates are revised.

We have calculated an APIC pool pursuant to the provisions of SFAS 123(R). The APIC pool represents the excess tax benefits related to stock-based compensation that are available to absorb future tax deficiencies. We include only those excess tax benefits that have been realized in accordance with SFAS No. 109, *Accounting for Income Taxes*. If the amount of future tax deficiencies is greater than the available APIC pool, we will record the excess as income tax expense in our consolidated statements of income. For the three and nine months ended September 30, 2006, we recorded tax deficiencies of $2.9 million and $10.0 million against the APIC pool; as a result, such deficiencies did not affect our results of operations. Excess tax benefits or tax deficiencies are a factor in the calculation of diluted shares used in computing dilutive earnings per share. The adoption of SFAS 123(R) did not have a material impact on our dilutive shares.

Prior to our adoption of SFAS 123(R), we recorded cash retained as a result of tax benefit deductions relating to stock-based compensation in operating activities in our consolidated statements of cash flows, along with other tax cash flows, in accordance with the provisions of the Emerging Issues Task Force (EITF) No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option* (EITF 00-15). SFAS 123(R) supersedes EITF 00-15, amends SFAS No. 95, *Statement of Cash Flows*, and requires that, upon adoption, we present the tax benefit deductions relating to excess stock-based compensation deductions as a financing activity in our consolidated

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Notes to Consolidated Financial Statements (Continued)

statements of cash flows. For the nine months ended September 30, 2006, we reported $0.8 million of tax benefit deductions as a financing activity that previously would have been reported as an operating activity.

Marketing Promotions

We periodically provide incentive offers to our customers to encourage booking of travel products and services. We record these incentive offers in accordance with EITF No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products),* and EITF No. 00-22, *Accounting for Points and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future.* Generally, our incentive offers are as follows:

Current Discount Offers. These promotions include dollar off discounts to be applied against current purchases. We record the discounts as reduction in revenue at the date we record the corresponding revenue transaction.

Inducement Offers. These promotions include discounts granted at the time of a current purchase to be applied against a future qualifying purchase. We treat inducement offers as a reduction to revenue based on estimated future redemption rates. We allocate the discount amount between the current purchase and the potential future purchase based on our expected relative value of the transactions. We estimate our redemption rates using our historical experience for similar inducement offers.

Concession Offers. These promotions include discounts to be applied against a future purchase to maintain customer satisfaction. Upon issuance, we record these concession offers as a r