

TRAVELZOO INC  
Form 10-Q  
October 24, 2013

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File No.: 000-50171

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

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

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

590 Madison Avenue, 37th Floor  
New York, New York  
(Address of principal executive offices)

10022  
(Zip code)

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

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of Travelzoo common stock outstanding as of October 24, 2013 was 15,361,873 shares.



TRAVELZOO INC.

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## PART I—FINANCIAL INFORMATION

## Item 1. Financial Statements

## TRAVELZOO INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par value)

	September 30, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$77,900	\$61,169
Accounts receivable, less allowance for doubtful accounts of \$416 and \$498 as of September 30, 2013 and December 31, 2012, respectively	14,818	13,626
Income tax receivable	4,504	6,682
Deposits	501	389
Prepaid expenses and other current assets	3,483	2,260
Deferred tax assets	2,007	2,194
Total current assets	103,213	86,320
Deposits, less current portion	979	1,107
Deferred tax assets, less current portion	1,229	1,710
Restricted cash	1,618	3,396
Property and equipment, net	6,376	4,314
Intangible assets, net	540	986
Total assets	\$113,955	\$97,833
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$27,676	\$28,695
Reserve for unexchanged promotional shares	25,000	3,000
Accrued expenses	10,043	8,993
Deferred revenue	1,740	2,698
Income tax payable	1,353	—
Deferred rent	306	280
Total current liabilities	66,118	43,666
Long-term tax liabilities	10,388	10,030
Deferred rent, less current portion	1,423	798
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.01 par value per share (5,000 shares authorized; none issued)	—	—
Common stock, \$0.01 par value (40,000 shares authorized; 15,801 shares issued and 15,362 shares outstanding as of September 30, 2013 and December 31, 2012)	163	163
Treasury stock (at cost, 438 shares at September 30, 2013 and December 31, 2012)	(7,898	) (7,898
Additional paid-in capital	9,851	8,863
Retained earnings	34,707	42,948
Accumulated other comprehensive loss	(797	) (737
Total stockholders' equity	36,026	43,339
Total liabilities and stockholders' equity	\$113,955	\$97,833

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Revenues	\$37,256	\$35,447	\$120,759	\$114,140
Cost of revenues	4,322	3,989	12,733	11,672
Gross profit	32,934	31,458	108,026	102,468
Operating expenses:				
Sales and marketing	18,449	17,427	57,563	49,753
General and administrative	10,510	9,836	30,659	28,583
Unexchanged promotional shares	22,000	—	22,000	3,000
Total operating expenses	50,959	27,263	110,222	81,336
Income (loss) from operations	(18,025	) 4,195	(2,196	) 21,132
Other income	224	135	369	218
Income (loss) before income taxes	(17,801	) 4,330	(1,827	) 21,350
Income taxes	1,235	896	6,414	6,908
Net income (loss)	\$(19,036	) \$3,434	\$(8,241	) \$14,442
Basic net income (loss) per share	\$(1.24	) \$0.22	\$(0.54	) \$0.91
Diluted net income (loss) per share	\$(1.24	) \$0.22	\$(0.54	) \$0.90
Shares used in computing basic net income (loss) per share	15,362	15,884	15,362	15,935
Shares used in computing diluted net income (loss) per share	15,362	15,922	15,362	16,041

See accompanying notes to unaudited condensed consolidated financial statements.

TRAVELZOO INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income (loss)	\$(19,036	) \$3,434	\$(8,241	) \$14,442
Other comprehensive income (loss):				
Foreign currency translation adjustment	1,319	756	(60	) 694
Total comprehensive income (loss)	\$(17,717	) \$4,190	\$(8,301	) \$15,136

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2013	2012
Cash flows from operating activities:		
Net income (loss)	\$(8,241	) \$14,442
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,185	1,856
Deferred income tax	641	(3
Stock-based compensation	989	900
Provision for losses on accounts receivable	(44	) 116
Net foreign currency effect	38	(6
Changes in operating assets and liabilities:		
Accounts receivable	(1,106	) (2,069
Deposits	17	(382
Income tax receivable	2,169	1,819
Prepaid expenses and other current assets	(975	) (241
Accounts payable	(1,041	) 1,189
Reserve for unexchanged promotional shares	22,000	3,000
Accrued expenses	1,039	3,198
Deferred revenue	(956	) 323
Deferred rent	299	21
Income tax payable	1,292	(284
Other non-current liabilities	359	(190
Net cash provided by operating activities	18,665	23,689
Cash flows from investing activities:		
Purchases of property and equipment	(3,596	) (2,046
Release of restricted cash	1,786	—
Net cash used in investing activities	(1,810	) (2,046
Cash flows from financing activities:		
Net cash used in financing activities	—	(3,611
Effect of exchange rate changes on cash and cash equivalents	(124	) 858
Net increase in cash and cash equivalents	16,731	18,890
Cash and cash equivalents at beginning of period	61,169	38,744
Cash and cash equivalents at end of period	\$77,900	\$57,634
Supplemental disclosure of cash flow information:		
Cash paid for income taxes, net	1,917	5,568

See accompanying notes to unaudited condensed consolidated financial statements.



TRAVELZOO INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: The Company and Basis of Presentation

Travelzoo Inc. (the "Company" or "Travelzoo") is a global Internet media company. We inform over 26 million subscribers in North America, Europe and Asia Pacific, as well as millions of website users, about the best travel, entertainment and local deals available from thousands of companies. Our deal experts source, research and test-book offers, recommending only those that meet Travelzoo's rigorous quality standards. We provide travel, entertainment, and local businesses with a fast, flexible, and cost effective way to reach millions of consumers. Our revenues are generated primarily from advertising fees. In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Limited and Travelzoo Japan K.K. under a license agreement with Travelzoo Inc. and is not owned by the Company. Our publications and products include the Travelzoo websites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, www.travelzoo.de, www.travelzoo.es, www.travelzoo.fr, among others), the Travelzoo Top 20 e-mail newsletter, the Newsflash e-mail alert service, the SuperSearch pay-per-click travel search tool, and the Travelzoo Network, a network of third-party websites that list travel deals published by Travelzoo. We also operate Fly.com, a travel search engine that allows users to quickly and easily find the best prices on flights from hundreds of airlines and online travel agencies. In addition, our Travelzoo websites include our Local Deals and Getaways products that allow our subscribers to purchase vouchers for deals from local businesses such as spas, hotels and restaurants. We receive a percentage of the face value of the voucher from the local businesses.

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

Ralph Bartel, who founded Travelzoo and who is a Director of the Company is the sole beneficiary of the Ralph Bartel 2005 Trust, which is the controlling shareholder of Azzurro Capital Inc. As of September 30, 2013, Azzurro is the Company's largest stockholder, holding approximately 47.1% of the Company's outstanding shares.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company and its results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and related notes as of and for the year ended December 31, 2012, included in the Company's Form 10-K filed with the SEC on February 11, 2013.

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

The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013 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 principal stockholder, Ralph Bartel. In 1998, Mr. Bartel founded Travelzoo.com Corporation, a Bahamas corporation, which issued 5,155,874 shares via the Internet to approximately 700,000 "Netsurfer stockholders" for no cash consideration, but subject to certain conditions as referred to below. In 1998, Mr. Bartel also founded Silicon Channels Corporation, a California corporation, to operate the Travelzoo website. During 2001, Travelzoo Inc. was formed as a subsidiary of Travelzoo.com Corporation, and Mr. Bartel contributed all of the outstanding shares of Silicon Channels Corporation to Travelzoo Inc. in exchange for 8,129,273 shares of Travelzoo Inc. and options to acquire an additional 2,158,349 shares at \$1.00. Mr. Bartel exercised these options in January 2009.

In April 2002, Travelzoo.com Corporation was merged into Travelzoo Inc. Under and subject to the terms of the merger agreement, holders of promotional shares of Travelzoo.com Corporation ("Netsurfers") who established that they had satisfied certain prerequisite qualifications were allowed a period of 2 years following the effective date of the merger to receive one share of Travelzoo Inc. in exchange for each share of common stock of Travelzoo.com Corporation. The records of Travelzoo.com Corporation showed that, assuming all of the shares applied for by the Netsurfer stockholders were validly issued, there were 11,295,874 shares of Travelzoo.com Corporation outstanding. As of April 25, 2004, two years following the effective date of the merger, 7,180,342 shares of Travelzoo.com Corporation had been exchanged for shares of Travelzoo Inc. Prior to that date, the remaining shares which were available for issuance pursuant to the merger agreement were also 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, 2013, there were 15,361,873 shares of common stock outstanding.

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the shares of Travelzoo which have not been claimed by former Netsurfer stockholders of Travelzoo.com, which remained unexchanged in the 2002 merger, as discussed in the preceding paragraph. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as "demandable" under Delaware escheat laws. While the Company continues to take the position that such shares were a promotional incentive and were issuable only to persons who establish their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a \$20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims.

Since March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the United States. The auditing firm representing these states in the reviews has presented to the Company preliminary findings which relate primarily to the promotional shares which remained unexchanged in the 2002 merger that were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3.0 million charge for the contingency related to the promotional shares which remained unexchanged in the 2002 merger.

In October 2013, the Company entered into agreements with 34 additional states to resolve those states' claims related to similar unclaimed property audits. The multi-state settlement relates to approximately 700,000 additional shares of the Company which could have been issued to residents of those states in the merger, which those states claim are subject to escheat. While the Company disputes the states' claims, the Company determined that it was in its best interest to resolve the disputes and settle with 34 of the states.

An additional 15 states remain that have or may raise claims on approximately 400,000 additional shares that were not claimed following the merger by residents in those states. The Company expects to make one-time cash payments to the 34 states after further due diligence, which it intends to make from cash on hand.

To cover those payments, as well as potential future settlements with the remaining 15 states, the Company recorded a \$22.0 million charge, during the three months ended September 30, 2013. The Company intends to make such payments from cash on hand. The payments to the states covered by the multi-state settlement are to be made following completion of further due diligence procedures, which are underway.

The Company intends to continue to challenge the applicability of escheat rights with the remaining 15 states, in that, among other reasons, the shares of the predecessor Bahamas corporation were offered for free as part of a promotional incentive program to qualified individuals. 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 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, and the remaining Netsurfer stockholders who have not qualified to receive shares in the Company, or who have not participated in the cash payments program referred to below, have not demonstrated their actual compliance with the conditions to the issuance of shares by Travelzoo.com Corporation. The Company does not know how many of the requests for shares originally received by Travelzoo.com Corporation in 1998 were valid, but the Company believes that only a portion of such requests were valid. In response to the pending reviews referred to above, and in response to other persons claiming to be former stockholders of Travelzoo.com Corporation, the Company intends to assert that the claimant must establish that the original Netsurfer stockholders complied with the conditions to issuance of their shares.

The ultimate resolution of this matter with the remaining states may take longer than one year; however, we have included the estimated loss for these remaining states potential claims in our reserves. The total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws, including whether penalties and interest are applicable.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfy the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$8,000 and \$22,000 for these cash payments for the three and nine months ended September 30, 2013, respectively.

The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

#### Note 2: Net Income (Loss) Per Share

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

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

	Three Months Ended September 30, 2013		September 30, 2012		Nine Months Ended September 30, 2013		2012	
Basic net income (loss) per share:								
Net income (loss)	\$ (19,036	) \$ 3,434	\$ (8,241	) \$ 14,442				
Weighted average common shares	15,362	15,884	15,362	15,935				
Basic net income (loss) per share	\$ (1.24	) \$ 0.22	\$ (0.54	) \$ 0.91				
Diluted net income (loss) per share:								
Net income (loss)	\$ (19,036	) \$ 3,434	\$ (8,241	) \$ 14,442				
Weighted average common shares	15,362	15,884	15,362	15,935				
Effect of dilutive securities: stock options	—	38	—	106				
Diluted weighted average common shares	15,362	15,922	15,362	16,041				
Diluted net income (loss) per share	\$ (1.24	) \$ 0.22	\$ (0.54	) \$ 0.90				



For the three and nine months ended September 30, 2013, options to purchase 475,000 shares of common stock were not included in the computation of diluted net loss per share because the effect would have been anti-dilutive. For the three and nine months ended September 30, 2012, options to purchase 100,000 shares of common stock were not included in the computation of diluted net income per share because the effect would have been anti-dilutive.

#### Note 3: Financial Instruments

At September 30, 2013, restricted cash consisted primarily of a certificate of deposit for \$875,000 serving as collateral for a standby letter of credit for the security deposit under the lease of our corporate headquarters and a \$743,000 deposit with our banks in Europe for our merchant accounts. Cash equivalents consist of highly liquid investments with remaining maturities of 3 months or less on the date of purchase held in money market funds. The Company believes that the carrying amounts of these financial assets are a reasonable estimate of their fair value and are categorized as Level 1. The fair value of these financial assets was determined using the following inputs at September 30, 2013 and December 31, 2012 (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Balance at September 30, 2013				
Money market funds	\$ 11,917	\$ 11,917	\$ —	\$ —
Total	\$ 11,917	\$ 11,917	\$ —	\$ —
Balance at December 31, 2012				
Money market funds	\$ 13,866	\$ 13,866	\$ —	\$ —
Total	\$ 13,866	\$ 13,866	\$ —	\$ —

At September 30, 2013, accounts receivable and accounts payable are not measured at fair value; however, the Company believes that the carrying amounts of these assets and liabilities are a reasonable estimate of their fair value. Accounts receivable and accounts payable are categorized as Level 2.

There have been no changes in Level 1, Level 2 and Level 3 and no changes in valuation techniques for these assets or liabilities for the period ended September 30, 2013.

#### Note 4: Intangible Assets

Intangible assets consist of the following (in thousands):

	September 30, 2013	December 31, 2012
Internet domain names and technology	\$2,798	\$2,805
Accumulated amortization	(2,258)	(1,819)
Total	\$540	\$986

Intangible assets have a useful life of 3 to 5 years. For the three months ended September 30, 2013 and 2012, amortization expense was \$144,000 and \$88,000, respectively. For the nine months ended September 30, 2013 and 2012, amortization expense was \$442,000 and \$264,000, respectively.

Future expected amortization expense related to intangible assets at September 30, 2013 is as follows (in thousands):

Remainder of 2013	\$ 146
2014	230
2015	164
Total	\$540

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

#### Note 5: Commitments and Contingencies

Beginning on August 9, 2011, two purported class action lawsuits were commenced in the U.S. District Court for the Southern District of New York. On January 6, 2012, a Consolidated and Amended Class Action Complaint was filed. The complaint asserted claims under Section 10(b) and 20(a) pursuant to the Securities Exchange Act of 1934 ("Exchange Act") alleging that between March 16, 2011 and July 21, 2011, the Company and/or the individual defendants purportedly issued materially false and misleading statements. In particular, the complaint asserted, among other things, allegations challenging certain statements relating to the Company's growth. The complaint also made allegations regarding the Company's Getaways product and asserted that certain officers and directors sold stock while in possession of materially adverse non-public information. The action sought unspecified damages and the Company was not able to estimate the possible loss or range of losses that could potentially result from the action. On March 29, 2013, the U.S. District Court for the Southern District of New York issued a decision and order, granting defendants' motions to dismiss and dismissing the securities action. The plaintiffs thereafter filed a notice of appeal. On September 20, 2013, the parties entered into a stipulation to withdraw the appeal and the appeal was withdrawn with prejudice. The Company continues to believe that the action was without merit.

In addition, five shareholder derivative lawsuits, Wang v. Bartel, et al., Wirth v. Bartel, et al., Kitt v. Bartel, et al., Blatt v. Bartel, et al., and Turansky v. Bartel, et al., were filed in the Southern District of New York based on similar allegations that sought to assert claims under state law derivatively on behalf of Travelzoo against certain officers and directors of the Company. These derivative actions were consolidated and on January 6, 2012, a Verified Consolidated Shareholder Derivative Complaint was filed purportedly on behalf of nominal defendant Travelzoo. The complaint asserted claims for breaches of fiduciary duties, unjust enrichment, abuse of control and gross mismanagement against current and former directors and officers of the Company. The complaint also asserted a breach of fiduciary duty claim for insider trading against certain officers and directors, as well as Azzurro Capital Inc. The derivative action made allegations regarding the Company's Getaways product and asserted that certain officers and directors sold stock while in possession of materially adverse non-public information. On March 29, 2013, the U.S. District Court for the Southern District of New York issued an order providing the plaintiffs with thirty days to decide whether they will file an amended Verified Consolidated Shareholder Derivative Complaint substituting or adding a shareholder plaintiff in the action. On May 6, 2013, the parties entered into a stipulation to dismiss the action and on May 7, 2013, the Court dismissed the action without prejudice. Since derivative claims are an attempt by a plaintiff shareholder to assert claims on behalf of the Company, we do not anticipate any potential loss to the Company from these actions.

On January 27, 2012, a purported shareholder of Travelzoo commenced a suit in the Supreme Court of New York that asserts claims derivatively on behalf of Travelzoo Inc. for breaches of fiduciary duty against Travelzoo's board of directors. The complaint also asserts claims for breaches of fiduciary duty and unjust enrichment against Ralph Bartel and Azzurro Capital Inc. The complaint challenges Travelzoo's sale of its Asia Pacific division for \$3.6 million to Azzurro and alleges that the transaction was not entirely fair to the Company. Since derivative claims are an attempt by a plaintiff shareholder to assert claims on behalf of the Company, we do not anticipate any potential loss to the Company from these actions.

On September 28, 2012, Metasearch Systems, LLC filed a lawsuit in the U.S. District Court for the Eastern District of Delaware against Travelzoo Inc. d/b/a Fly.com alleging infringement of several U.S. patents. Metasearch Systems alleges that the trip-planning metasearch service available on Fly.com infringes one or more claims of the asserted patents. During September 2012, Metasearch Systems filed similar lawsuits against several of Travelzoo's competitors



including Expedia, Inc., Orbitz Worldwide, Inc., Travelocity.com, LP, Priceline.com, Inc., Yahoo! Inc., American Express Company, Kayak Software Corp., and BookIt.com. The action seeks unspecified damages and we are unable to estimate the possible loss or range of losses that could potentially result from the action. The Company believes that the action is without merit and intends to defend the suit vigorously.

On April 21, 2011, the Company entered into an agreement with the State of Delaware resolving all claims relating to an unclaimed property review which began in 2010. The primary issue raised in the preliminary findings from the review, received by the Company on April 12, 2011, concerned the promotional shares which remained unexchanged in the 2002 merger (unexchanged promotional shares) as discussed further in Note 1. In the preliminary findings under the unclaimed property review, up to 3.0 million shares were identified as “demandable” under Delaware escheat laws. While the Company continues to take the position that such shares were a promotional incentive and were issuable only to persons who established their eligibility as stockholders, the Company determined that it was in its best interest to promptly resolve all claims relating to the unclaimed property review. The Company made a \$20.0 million cash payment to the State of Delaware on April 27, 2011 and received a complete release of those claims. As discussed in Note 1 above, since March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged promotional shares, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3.0 million charge related to this unexchanged promotional shares contingency.

In October 2013, the Company entered into agreements with 34 additional states to resolve those states’ claims related to similar unclaimed property audits. The multi-state settlement relates to approximately 700,000 additional shares of the Company which could have been issued to residents of those states in the merger, which those states claim are subject to escheat. While the Company disputes the states’ claims, the Company determined that it was in its best interest to resolve the disputes and settle with 34 of the states.

An additional 15 states remain that have or may raise claims on approximately 400,000 shares that were not claimed following the merger by residents in those states. The Company expects to make one-time cash payments to the 34 states after further due diligence, which it intends to make from cash on hand.

To cover those payments, as well as potential future settlements with the remaining 15 states, the Company recorded a \$22.0 million charge, during the three months ended September 30, 2013. The Company intends to make such payments from cash on hand. The payments to the states covered by the multi-state settlement are to be made following completion of further due diligence procedures, which are underway.

The ultimate resolution of this matter with the remaining states may take longer than one year; however, we have included the estimated loss for these remaining states potential claims in our reserves. The total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws, including whether penalties and interest are applicable.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfied the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$8,000 and \$22,000 for these cash payments for the three and nine months ended September 30, 2013, respectively.

The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company’s common stock price, and would be affected by any settlement of the pending unclaimed property reviews referred to above. The Company’s common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received.

The Company leases office space in Canada, France, Germany, Spain, the U.K., and the U.S. under operating leases which expire between October 31, 2013 and January 1, 2024. The future minimum lease payments under these operating leases as of September 30, 2013 total \$33.1 million. The future lease payments consist of \$1,425,000 due in 2013, \$4,841,000 due in 2014, \$4,601,000 due in 2015, \$4,072,000 due in 2016, \$3,530,000 due in 2017, and \$14,595,000 thereafter.

Local Deals and Getaways merchant payable included in accounts payable was \$21.9 million and \$23.4 million, as of September 30, 2013 and December 31, 2012, respectively.



#### Note 6: Stock-Based Compensation

In November 2009, the Company granted an executive stock options to purchase 300,000 shares of common stock with an exercise price of \$14.97, of which 75,000 options vest and become exercisable annually starting July 1, 2011. The options expire in November 2019. As of September 30, 2013, 225,000 of these options were vested and 300,000 options were outstanding. Total stock-based compensation for the three months ended September 30, 2013 and 2012 related to this 300,000 option grant was \$187,000 for each period. Total stock-based compensation for the nine months ended September 30, 2013 and 2012 related to this 300,000 option grant was \$562,000 for each period. As of September 30, 2013, there was approximately \$562,000 of unrecognized stock-based compensation expense relating to these options. This amount is expected to be recognized over 1.0 year.

In January 2012, the Company granted executives stock options to purchase 100,000 shares of common stock with an exercise price of \$28.98, of which 25,000 options become exercisable annually starting January 23, 2013. The options expire in January 2022. As of September 30, 2013, 25,000 of these options were vested and 100,000 options were outstanding. Total stock-based compensation for the three months ended September 30, 2013 and 2012 related to this 100,000 option grant was \$119,000 for each period. Total stock-based compensation for the nine months ended September 30, 2013 and 2012 related to this 100,000 option grant was \$358,000 and \$338,000, respectively. As of September 30, 2013, there was approximately \$1.1 million of unrecognized stock-based compensation expense relating to these options. This amount is expected to be recognized over 2.3 years. The Company used a forfeiture rate of 0% as the Company does not have enough historical forfeiture data to estimate the forfeiture rate. To the extent the actual forfeiture rate is greater than what we have anticipated, stock-based compensation related to these options will be lower than our expectations.

In July 2013, the Company granted an executive stock options to purchase 75,000 shares of common stock with an exercise price of \$29.58, of which 25,000 options become exercisable annually starting July 1, 2015. The options expire in July 2023. As of September 30, 2013, none of these options was vested and 75,000 options were outstanding. Total stock-based compensation for the three months ended September 30, 2013 related to this 75,000 option grant was \$69,000. As of September 30, 2013, there was approximately \$1.3 million of unrecognized stock-based compensation expense relating to these options. This amount is expected to be recognized over 3.9 years. The Company used a forfeiture rate of 0% as the Company does not have enough historical forfeiture data to estimate the forfeiture rate. To the extent the actual forfeiture rate is greater than what we have anticipated, stock-based compensation related to these options will be lower than our expectations.

#### Note 7: Income Taxes

In determining the quarterly provisions for income taxes, the Company uses an estimated annual effective tax rate, which is generally based on our expected annual income and statutory tax rates in the U.S., Canada and U.K. For the nine months ended September 30, 2013, the Company's effective tax rate was (351.1)%, treating the \$22.0 million expense for unexchanged promotional shares as having no recognizable tax benefits, which changed the Company's effective tax rate by 382.9%. For the nine months ended September 30, 2012, the Company's effective tax rate was 32%, treating the \$3.0 million expense for unexchanged promotional shares as having no recognizable tax benefits, which increased the Company's effective tax rate by 4%.

U.S. income and foreign withholding taxes have not been provided on undistributed earnings for certain non-U.S. subsidiaries. The undistributed earnings on a book basis for the non-U.S. subsidiaries as of September 30, 2013 are approximately \$2.6 million. The Company intends to reinvest these earnings indefinitely in its operations outside the U.S. If the undistributed earnings are remitted to the U.S. these amounts would be taxable in the U.S. at the current federal and state tax rates net of foreign tax credits. Also, depending on the jurisdiction any distribution may be subject to withholding taxes at rates applicable for that jurisdiction.

The Company maintains liabilities for uncertain tax positions. To the extent accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction in the overall income tax provision in the period that such determination is made. At September 30, 2013, the Company had approximately \$9.4 million in total unrecognized tax benefits, consisting of unrecognized tax benefits of approximately \$8.0 million which, if recognized, would favorably affect the Company's effective income tax rate, and unrecognized tax benefits of approximately \$1.4 million, which if recognized, would be recorded in discontinued operations.



The Company's policy is to include interest and penalties related to unrecognized tax positions in income tax expense. As of September 30, 2013 and December 31, 2012, the Company had approximately \$984,000 and \$664,000, respectively, in accrued interest and penalties related to uncertain tax positions. The Company is in various stages of multiple year examinations by federal and state taxing authorities. Although the timing of resolution and/or closure on audits is highly uncertain, it is reasonably possible that the balance of the gross unrecognized tax benefits related to the method of computing income taxes in certain jurisdiction and losses reported on certain income tax returns could significantly change in the next 12 months. These changes may occur through settlement with the taxing authorities or the expiration of the statute of limitations on the returns filed. The Company is unable to estimate the range of possible adjustments to the balance of the gross unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The Company is subject to U.S. federal and certain state tax examinations for years after 2008 and is subject to California tax examinations for years after 2004. The Company's 2009 and 2010 federal income returns are currently under examination, including the impact of the sale of Asia Pacific business segment in 2009.

#### Note 8: Segments

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

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

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

Three Months Ended September 30, 2013	North America	Europe	Elimination and Other (a)	Consolidated
Revenues from unaffiliated customers	\$26,209	\$11,047	\$—	\$37,256
Intersegment revenues	361	110	(471 )	—
Total net revenues	26,570	11,157	(471 )	37,256
Operating income (loss)	\$2,506	\$1,469	\$(22,000 )	\$(18,025 )
Three Months Ended September 30, 2012	North America	Europe	Elimination	Consolidated
Revenues from unaffiliated customers	\$25,147	\$10,300	\$—	\$35,447
Intersegment revenues	211	10	(221 )	—
Total net revenues	25,358	10,310	(221 )	35,447
Operating income	\$3,121	\$1,074	\$—	\$4,195
Nine Months Ended September 30, 2013	North America	Europe	Elimination and Other (b)	Consolidated
Revenues from unaffiliated customers	\$86,368	\$34,391	\$—	\$120,759
Intersegment revenues	757	440	(1,197 )	—
Total net revenues	87,125	34,831	(1,197 )	120,759
Operating income (loss)	\$13,888	\$5,916	(22,000 )	\$(2,196 )

Nine Months Ended September 30, 2012	North America	Europe	Elimination and Other (b)	Consolidated
Revenues from unaffiliated customers	\$82,415	\$31,725	\$—	\$114,140
Intersegment revenues	496	41	(537 )	—
Total net revenues	82,911	31,766	(537 )	114,140
Operating income	\$18,094	\$6,038	\$(3,000 )	\$21,132

(a) Amount represents a charge related to unexchanged promotional shares of \$22.0 million for the three months ended September 30, 2013.

(b) Amount represents a charge related to unexchanged promotional shares of \$22.0 million and \$3.0 million for the nine months ended September 30, 2013 and September 30, 2012, respectively.

As of September 30, 2013	North America	Europe	Elimination	Consolidated
Long-lived assets	\$4,918	\$1,998	\$—	\$6,916
Total assets	\$102,476	\$42,531	\$(31,052 )	\$113,955

As of December 31, 2012	North America	Europe	Elimination	Consolidated
Long-lived assets	\$3,389	\$1,911	\$—	\$5,300
Total assets	\$92,139	\$36,595	\$(30,901 )	\$97,833

Revenue for each segment is recognized based on the customer location within a designated geographic region.

Property and equipment are attributed to the geographic region in which the assets are located.

For the three and nine months ended September 30, 2013 and 2012, the Company did not have any customers that accounted for 10% or more of revenue. As of September 30, 2013 and December 31, 2012, the Company did not have any customers that accounted for 10% or more of accounts receivable.

The following table sets forth the breakdown of revenues (in thousands) by type and segment for the three and nine months ended September 30, 2013 and 2012. Travel revenue includes travel publications (Top 20, Website, Newsflash, Travelzoo Network) and Getaways vouchers. Search revenue includes SuperSearch and Fly.com. Local revenue includes Local Deals vouchers and entertainment offers (vouchers and direct bookings).

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
North America				
Travel	\$14,940	\$12,606	\$48,892	\$42,743
Search	5,173	5,737	16,856	17,727
Local	6,096	6,804	20,620	21,945
Total North America revenues	\$26,209	\$25,147	\$86,368	\$82,415
Europe				
Travel	\$8,298	\$7,368	\$25,772	\$22,304
Search	828	1,026	2,539	3,328
Local	1,921	1,906	6,080	6,093
Total Europe revenues	\$11,047	\$10,300	\$34,391	\$31,725
Consolidated				
Travel	\$23,238	\$19,974	\$74,665	\$65,047
Search	6,001	6,763	19,394	21,055
Local	8,017	8,710	26,700	28,038
Total revenues	\$37,256	\$35,447	\$120,759	\$114,140

#### Note 9: Related Party Transactions

Ralph Bartel, who founded Travelzoo and who is a Director of the Company is the sole beneficiary of the Ralph Bartel 2005 Trust, which is the controlling shareholder of Azzurro Capital Inc. As of September 30, 2013, Azzurro is the Company's largest stockholder, holding approximately 47.1% of the Company's outstanding shares.

In 2009, the Company sold its Asia Pacific operating segment to Travelzoo (Asia) Limited and Travelzoo Japan K.K., subsidiaries of Azzurro. The Company's receivables from Travelzoo (Asia) Limited and Travelzoo Japan K.K. totaled \$733,000 and \$355,000 as of September 30, 2013 and December 31, 2012, respectively, and were related primarily to fees under a Hosting Agreement and a Referral Agreement entered into in connection with the sale transaction. The \$733,000 and \$355,000 are part of prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheets.



## Note 10: Accumulated Other Comprehensive Income

The following table summarizes the changes in accumulated balances of other comprehensive income (in thousands) for the three and nine months ended September 30, 2013 and for the three and nine months ended September 30, 2012:

	Foreign Currency Translation	Total
<b>Three Months Ended September 30, 2013</b>		
Beginning balance	\$(2,116 )	\$(2,116 )
Other comprehensive income before reclassifications	1,319	1,319
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income	1,319	1,319
Ending balance	\$(797 )	\$(797 )
<b>Nine Months Ended September 30, 2013</b>		
Beginning balance	\$(737 )	\$(737 )
Other comprehensive income before reclassifications	(60 )	(60 )
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income	(60 )	(60 )
Ending balance	\$(797 )	\$(797 )
<b>Three Months Ended September 30, 2012</b>		
Beginning balance	\$(1,484 )	\$(1,484 )
Other comprehensive income before reclassifications	756	756
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income	756	756
Ending balance	\$(728 )	\$(728 )
<b>Nine Months Ended September 30, 2012</b>		
Beginning balance	\$(1,422 )	\$(1,422 )
Other comprehensive income before reclassifications	694	694
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income	694	694
Ending balance	\$(728 )	\$(728 )

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

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

Overview

Travelzoo Inc. (the "Company" or "Travelzoo") is a global Internet media company. We inform over 26 million subscribers in North America, Europe and Asia Pacific, as well as millions of website users, about the best travel and entertainment deals available from thousands of companies. Our deal experts source, research and test-book offers, recommending only those that meet Travelzoo's rigorous quality standards. We provide travel, entertainment and local businesses with a fast, flexible, and cost-effective way to reach millions of consumers. Our revenues are generated primarily from advertising fees. In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Limited and Travelzoo Japan K.K. under a License agreement with Travelzoo Inc. and is not owned by the Company. Our publications and products include the Travelzoo websites (www.travelzoo.com, www.travelzoo.ca, www.travelzoo.co.uk, www.travelzoo.de, www.travelzoo.es, www.travelzoo.fr, among others), the Travelzoo Top 20 e-mail newsletter, and the Newsflash e-mail alert service. We operate SuperSearch, a pay-per-click travel search tool, and the Travelzoo Network, a network of third-party websites that list deals published by Travelzoo. We also operate Fly.com, a travel search engine that allows users to quickly and easily find the best prices on flights from hundreds of airlines and online travel agencies. In addition, our Travelzoo websites include our Local Deals and Getaways products that allow our subscribers to purchase vouchers for deals from local businesses such as spas, hotels and restaurants. We receive a percentage of the face value of the voucher from the local businesses. On October 31, 2009, we completed the sale of our Asia Pacific operating segment to Travelzoo (Asia) Limited and Travelzoo Japan K.K., subsidiaries of Azzurro. We have not had significant ongoing involvement with the operations of the Asia Pacific operating segment and have not had material economic interests in the Asia Pacific operating segment since the completion of the sale. Starting November 1, 2009, the Travelzoo websites in Asia Pacific (cn.travelzoo.com, www.travelzoo.co.jp, www.travelzoo.com.au, www.travelzoo.com.hk, www.travelzoo.com.tw, among others), the Travelzoo Top 20 e-mail newsletters in Asia Pacific and the Newsflash e-mail alert service in Asia Pacific have been published by Travelzoo (Asia) Limited and Travelzoo Japan K.K., under a license agreement with the Company. There is a reciprocal revenue-sharing agreement among the entities operating the Travelzoo business in Asia Pacific and the Company related to cross-selling audiences. More than 2,000 companies use our services, including Air New Zealand, Apple Vacations, British Airways, Harrah's Entertainment, Expedia, Fairmont Hotels and Resorts, Hilton Hotels, Interstate Hotels & Resorts, Liberty Travel, Marriott Hotels, Royal Caribbean, Spirit Airlines, Starwood Hotels & Resorts Worldwide, Travelocity, United Airlines, and Virgin Atlantic.

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

the three months ended September 30, 2013, European operations were 30% of revenues. Financial information with respect to our business segments and certain financial information about geographic areas appears in Note 8 to the accompanying consolidated financial statements.

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

#### How We Generate Revenue

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

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

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

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

#### Trends in Our Business

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

Our current revenue model depends on advertising fees paid primarily by travel, entertainment and local businesses. A number of factors can influence whether current and new advertisers decide to advertise their offers with us. We have been impacted and expect to continue to be impacted by external factors such as the shift from offline to online advertising, the relative condition of the economy, competition and the introduction of new methods of advertising. For example, the consolidation of the airline industry reduced our revenues generated from this sector, the reduction of capacity in the airline industry reduced demand to advertise for excess capacity, the introduction of new voucher-based products offered by competitive companies impacted our ability to sell our existing advertising products, the reduction in spending by travel intermediaries due to their focus on improving profitability, the trend towards mobile usage by consumers, the willingness of consumers to purchase the deals we advertise, the willingness of certain competitors to grow their business unprofitably and the economic uncertainty in Europe impacted

advertisers' willingness to purchase our advertising. In addition, we have been impacted and expect to continue to be impacted by internal factors such as introduction of new advertising products, hiring and relying on key employees for the continued maintenance and growth of our business and ensuring our advertising products continue to attract the audience that advertisers desire.

Existing advertisers may shift from one advertising service (e.g. Top 20) to another (e.g. Local Deals and Getaways). These shifts between advertising services by advertisers could result in no incremental revenue or less revenue than in previous periods depending on the amount purchased by the advertisers, and in particular, with Local Deals and Getaways, depending on how many vouchers are purchased by subscribers. Since the introduction of Local Deals in 2010 and Getaways in 2011, we have seen a decline in the average number of vouchers sold per deal.

Our ability to continue to generate advertising revenue depends heavily upon our ability to maintain and grow an attractive audience to reach with our advertising publications. We monitor the subscribers to our websites to assess our efforts to maintain and grow our audience reach. We obtain additional subscribers and activity on our websites by acquiring traffic from Internet search companies. The costs to grow our audience have had, and we expect will continue to have, a significant impact on our financial results and can vary from period to period. We may have to increase our expenditures on acquiring traffic to continue to grow or maintain our reach of our publications due to competition. Recently, we have seen a shift in the audience to accessing our services through mobile devices and social media. We are starting to address this growing channel of our audience through development of our mobile applications and through marketing on social media channels. However, we will have to keep pace with technological change and trend to further address this shift in the audience behavior.

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

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

We do not know what our sales and marketing expenses as a percentage of revenue will be in future periods. Increased competition in our industry may require us to increase advertising for our brand and for our products. In order to increase the reach of our publications, we have to acquire a significant number of new subscribers in every quarter and continue to promote our brand. One significant factor that impacts our advertising expenses is the average cost per acquisition of a new subscriber. Increases in the average cost of acquiring new subscribers may result in an increase of sales and marketing expenses as a percentage of revenue. We believe that the average cost per acquisition depends mainly on the advertising rates which we pay for media buys, our ability to manage our subscriber acquisition efforts successfully, and the degree of competition in our industry. We may decide to accelerate our subscriber acquisition for various strategic and tactical reasons and, as a result, increase our marketing expenses. We may see a unique opportunity for a brand marketing campaign that will result in an increase of marketing expenses. Further, we expect our strategy to replicate our business model in selected foreign markets to result in a significant increase in our sales and marketing expenses and have a material adverse impact on our results of operations. Due to the continued desire to grow our business both in the North America and Europe we expect relatively high level of sales and marketing expenses in the foreseeable future. We expect fluctuations of sales and marketing expenses as a percentage of revenue from year to year and from quarter to quarter. Some of the fluctuations may be significant and have a material impact on our results of operations. We expect increased marketing expense to spur continued growth in subscribers and revenue in future periods; however, we cannot be assured of this due to the many factors that impact our growth in subscribers and revenue. We expect to adjust the level of such incremental spending during any given quarter based upon market conditions, as well as our performance in each quarter. We have increased and may continue to increase our spending on sales and marketing to increase the number of our subscribers and address the growing audience from mobile and social media channels, as well as to increase our analytic capabilities to continuously improve the

presentation of our offerings to our audience.

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We do not know what our general and administrative expenses as a percentage of revenue will be in future periods. There may be fluctuations that have a material impact on our results of operations. We expect our headcount to continue to increase in the future. The Company's headcount is one of the main drivers of general and administrative expenses. Therefore, we expect our absolute general and administrative expenses to continue to increase. We expect our continued expansion into foreign markets and development of new advertising formats to result in a significant additional increase in our general and administrative expenses. Our general and administrative expenses as a percentage of revenue may also fluctuate depending on the number of requests received related to a program under which the Company intends to make cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert shares into Travelzoo Inc. within the required time period. We expect an increase in legal and professional fees in excess of \$300,000 due primarily to our compliance efforts. In addition, we expect to incur additional costs related to the development of our hotel booking platform capabilities, which we are developing, in part, to address the shift to mobile devices, compared to the three months ended September 30, 2013, resulting in an incremental cost in excess of \$400,000 during the three months ending December 31, 2013.

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

The key elements of our growth strategy include building strong brand awareness, increasing reach, maintaining a high-quality user base, increasing the number of advertisers, providing advertisers with excellent service and replicating our business model in foreign markets, as well as developing new products that keep pace with changes in consumer preferences and technology, such as the trend toward mobile usage by consumers. We expect to continue our efforts to grow; however, we may not grow or we may experience slower growth. Some examples of our efforts to expand our business internationally since our inception in the U.S. have been expansion to the U.K. in 2005, Canada in 2006, Germany in 2006, France in 2007 and Spain in 2008. We also have launched new products to grow our revenue, such as the introduction of Fly.com in 2009, Local Deals in 2010, Getaways in 2011, as well as our mobile application launches in 2011 and 2012. Recently, we bought an online hotel booking platform to assist in our development of a product to better serve hotels and to facilitate a hotel commission-based offering. We have also increased our spending on addressing the shift of our audience to mobile devices and social media.

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



Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
Revenues	100.0	% 100.0	% 100.0	% 100.0	%
Cost of revenues	11.6	11.3	10.5	10.2	
Gross profit	88.4	88.7	89.5	89.8	
Operating expenses:					
Sales and marketing	49.5	49.2	47.7	43.6	
General and administrative	28.2	27.7	25.4	25.0	
Unexchanged promotional shares	59.1	—	18.2	2.6	
Total operating expenses	136.8	76.9	91.3	71.2	
Income (loss) from operations	(48.4	) 11.8	(1.8	) 18.6	
Other income and expenses, net	0.6	0.4	0.3	0.2	
Income (loss) before income taxes	(47.8	) 12.2	(1.5	) 18.8	
Income taxes	3.3	2.5	5.3	6.1	
Net income (loss)	(51.1	)% 9.7	% (6.8	)% 12.7	%

## Operating Metrics

The following table sets forth operating metrics in North America and Europe for the three months ended September 30, 2013 and 2012:

	Three Months Ended September 30,	
	2013	2012
North America		
Total Subscribers	16,530,000	16,075,000
Average cost per acquisition of a new subscriber	\$1.61	\$1.95
Revenue per employee (2)	\$367,000	\$393,000
Revenue per subscriber (3)	\$6.52	\$6.42
Europe		
Total Subscribers	6,702,000	6,316,000
Average cost per acquisition of a new subscriber	\$2.68	\$3.55
Revenue per employee (2)	\$273,000	\$273,000
Revenue per subscriber (3)	\$6.94	\$7.10
Consolidated		
Total Subscribers (1)	23,232,000	22,391,000
Average cost per acquisition of a new subscriber	\$1.91	\$2.60
Revenue per employee (2)	\$333,000	\$348,000
Revenue per subscriber (3)	\$6.64	\$6.61

In Asia Pacific, the Travelzoo business is operated by Travelzoo (Asia) Limited, and Travelzoo Japan K.K. under a (1) license agreement with Travelzoo Inc. The total subscriber amounts exclude Asia Pacific subscribers of 3,600,000 for each of the three months ended September 30, 2013 and 2012.

(2) Annualized revenue divided by number of employees at the end of the quarter.

(3) Annualized revenue divided by number of subscribers at the beginning of the year.

## Revenues

The following table sets forth the breakdown of revenues (in thousands) by type and segment for the three and nine months ended September 30, 2013 and 2012. Travel revenue includes travel publications (Top 20, Website, Newsflash, Travelzoo Network) and Getaways vouchers. Search revenue includes SuperSearch and Fly.com. Local revenue includes Local Deals vouchers and entertainment offers (vouchers and direct bookings).

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
North America				
Travel	\$14,940	\$12,606	\$48,892	\$42,743
Search	5,173	5,737	16,856	17,727
Local	6,096	6,804	20,620	21,945
Total North America revenues	\$26,209	\$25,147	\$86,368	\$82,415
Europe				
Travel	\$8,298	\$7,368	\$25,772	\$22,304
Search	828	1,026	2,539	3,328
Local	1,921	1,906	6,080	6,093
Total Europe revenues	\$11,047	\$10,300	\$34,391	\$31,725
Consolidated				
Travel	\$23,238	\$19,974	\$74,665	\$65,047
Search	6,001	6,763	19,394	21,055
Local	8,017	8,710	26,700	28,038
Total revenues	\$37,256	\$35,447	\$120,759	\$114,140

## North America

North America revenues increased \$1.1 million for the three months ended September 30, 2013 from the three months ended September 30, 2012. This increase was primarily due to the growth of Travel revenues, offset by a decrease in Local and Search revenues. The increase in Travel revenues of \$2.3 million was primarily due to an increase in revenue from Getaways due to increased number of Getaways vouchers sold and an increase in revenues from travel publication due to increased number of e-mails delivered. The decrease in Local revenues of \$708,000 was primarily due to the decreased number of Local Deals vouchers sold. The decrease in Search revenue of \$564,000 was primarily due to the decreased number of clicks that generate revenue.

North America revenues increased \$4.0 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. This increase was primarily due to growth of Travel revenues offset by decreases in Local and Search revenues. The increase in Travel revenues of \$6.2 million was primarily due to an increase in revenues from Getaways due to increased number of Getaways vouchers sold and an increase in revenues from travel publication due to increased number of e-mails delivered. The decrease in Local revenues of \$1.3 million was primarily due to the decreased number of Local Deals vouchers sold. The decrease in Search revenue of \$871,000 was primarily due to the decreased number of clicks that generate revenue.

## Europe

Europe revenues increased \$747,000 for the three months ended September 30, 2013 from the three months ended September 30, 2012. This increase was primarily due to the growth of Travel revenues, offset by a decrease in Search revenue. The increase in Travel revenue of \$930,000 was primarily due to an increase in revenue from Getaways due to increased number of Getaways vouchers sold and an increase in revenues from travel publication due to increased number of e-mails delivered. The decrease in Search revenue of \$198,000 was primarily due to the decreased number of clicks that generate revenue.

Europe revenues increased \$2.7 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. This increase was primarily due to growth of Travel revenues, offset by a decrease in Search revenue. The increase in Travel revenue of \$3.5 million was primarily due to an increase in revenue from Getaways due to increased number of Getaways vouchers sold. The decrease in Search revenue of \$789,000 was primarily due to the decreased number of clicks that generate revenue as a result of decreased spending on traffic acquisition. For the three and nine months ended September 30, 2013 and September 30, 2012, none of our customers accounted for 10% or more of our revenue.

Foreign currency movements relative to the U.S. dollar positively impacted our revenues from our operations in Europe by approximately \$59,000 for the three months ended September 30, 2013. Foreign currency movements relative to the U.S. dollar positively impacted our revenues from our operations in Europe by approximately \$20,000 for the three months ended September 30, 2012.

Foreign currency movements relative to the U.S. dollar negatively impacted our revenues from our operations in Europe by approximately \$180,000 for the nine months ended September 30, 2013. Foreign currency movements relative to the U.S. dollar negatively impacted our revenues from our operations in Europe by approximately \$99,000 for the nine months ended September 30, 2012.

#### Cost of Revenues

Cost of revenues consists primarily of network expenses, including fees we pay for co-location services and depreciation and maintenance of network equipment, payments made to third-party partners of the Travelzoo Network, fees we pay related to user searches on Fly.com, amortization of capitalized website development costs, credit card fees, certain estimated subscriber refunds and customer service costs associated with vouchers we sell, and salary expenses associated with network operations and customer service staff. Cost of revenues was \$4.3 million and \$4.0 million for the three months ended September 30, 2013 and September 30, 2012, respectively. Cost of revenues was \$12.7 million and \$11.7 million for the nine months ended September 30, 2013 and September 30, 2012, respectively.

Cost of revenue increased \$333,000 for the three months ended September 30, 2013 from the three months ended September 30, 2012, due primarily to an increase of \$436,000 in payments made to third-party partners of the Travelzoo Network. Cost of revenue increased \$1.1 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012, due primarily to an increase of \$817,000 in payments made to third-party partners of the Travelzoo Network.

#### Operating Expenses

##### Sales and Marketing

Sales and marketing expenses consist primarily of advertising and promotional expenses, salary expenses associated with sales, marketing and production staff, expenses related to our participation in industry conferences, and public relations expenses. Sales and marketing expenses were \$18.4 million and \$17.4 million for the three months ended September 30, 2013, and September 30, 2012, respectively. For the three months ended September 30, 2013 and 2012, advertising expenses accounted for 37% and 42%, respectively, of total sales and marketing expenses and consisted primarily of online advertising referred to as traffic acquisition cost and subscriber acquisition costs. The goal of our advertising was to acquire new subscribers to our e-mail products, increase the traffic to our websites, increase brand awareness and increase our audience through mobile and social media channels.

Sales and marketing expenses were \$57.6 million and \$49.8 million for the nine months ended September 30, 2013 and September 30, 2012, respectively. For the nine months ended September 30, 2013 and 2012, advertising expenses accounted for 37% and 42%, respectively, of total sales and marketing expenses.

Sales and marketing expenses increased \$1.0 million for the three months ended September 30, 2013 from the three months ended September 30, 2012. The increase was primarily due to a \$2.2 million increase in salary and employee related expenses due primarily to an increase in headcount, offset by a \$570,000 decrease in subscriber acquisition costs and a \$398,000 decrease in Search traffic acquisition costs. These increases in salary and employee related expenses were aligned with our investments intended to drive future growth, which were focused on increasing sales

headcount, our analytic capabilities and our audience, both in terms of number of subscribers and the size of our audience from growing sources such as mobile devices and social media.

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Sales and marketing expenses increased \$7.8 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. The increase was primarily due to a \$7.9 million increase in salary and employee related expenses due primarily to an increase in headcount. This increase was aligned with our investments intended to drive future growth, which were focused on increasing sales headcount, our analytic capabilities and our audience, both in terms of number of subscribers and the size of our audience from growing sources such as mobile devices and social media.

#### General and Administrative

General and administrative expenses consist primarily of compensation for administrative, executive, and software development staff, fees for professional services, rent, bad debt expense, amortization of intangible assets, and general office expense. General and administrative expenses were \$10.5 million and \$9.8 million for the three months ended September 30, 2013 and September 30, 2012, respectively. General and administrative expenses were \$30.7 million and \$28.6 million for the nine months ended September 30, 2013 and September 30, 2012, respectively.

General and administrative expenses increased \$674,000 for the three months ended September 30, 2013 from the three months ended September 30, 2012. The increase was primarily due to a \$559,000 increase in professional services and other expenses.

General and administrative expenses increased \$2.1 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. The increase was primarily due to a \$2.6 million increase in salary and employee related expenses due primarily to an increase in headcount, and offset by a \$506,000 decrease in rent, office and insurance expense.

#### Unexchanged Promotional Shares

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

Since March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged promotional shares, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3.0 million charge related to this unexchanged promotional shares contingency.

In October 2013, the Company entered into agreements with 34 additional states to resolve those states' claims related to similar unclaimed property audits. The multi-state settlement relates to approximately 700,000 additional shares of the Company which could have been issued to residents of those states in the merger, which those states claim are subject to escheat. While the Company disputes the states' claims, the Company determined that it was in its best interest to resolve the disputes and settle with 34 of the states.

An additional 15 states remain that have or may raise claims on a remaining approximately 400,000 shares that were not claimed following the merger by residents in those states. The Company expects to make one-time cash payments to the 34 states after further due diligence, which it intends to make from cash on hand.

To cover those payments, as well as potential future settlements with the remaining 15 states, the Company recorded a \$22.0 million charge, during the three months ended September 30, 2013. The Company intends to make such payments from cash on hand. The payments to the states covered by the multi-state settlement are to be made following completion of further due diligence procedures, which are underway.

The ultimate resolution of this matter with the remaining states may take longer than one year; however, we have included the estimated loss for these remaining states potential claims in our reserves. The total amount of exposure of

this contingency is dependent upon the manner in which each state applies its unclaimed property laws, including whether penalties and interest are applicable. See Note 1 to the condensed consolidated financial statements for further information on the unexchanged promotional shares contingency.

## Income Taxes

Our income is generally taxed in the U.S., Canada, and U.K. Our income tax provisions reflect federal, state and country statutory rates applicable to our levels of worldwide income, adjusted to take into account expenses that are treated as having no recognizable tax benefit. Income tax expense was \$1.2 million and \$896,000 for the three months ended September 30, 2013 and 2012, respectively. Our effective tax rate was (7)% and 21% for the three months ended September 30, 2013 and 2012, respectively. Income tax expense was \$6.4 million and \$6.9 million for the nine months ended September 30, 2013 and 2012, respectively. Our effective tax rate was (351)% and 32% for the nine months ended September 30, 2013 and 2012, respectively.

Our effective tax rate increased for the nine months ended September 30, 2013 from the nine months ended September 30, 2012 due primarily to the \$22.0 million expense for the unexchanged promotional shares that was treated as having no recognizable tax benefits in the nine months ended September 30, 2013 compared to the \$3.0 million expense for the unexchanged promotional shares that was treated as having no recognizable tax benefits in the nine months ended September 30, 2012. Our effective tax rate for the nine months ended September 30, 2013 includes the benefit of Europe's utilization in 2013 of its accumulated losses. Subject to Europe generating sufficient future income, we expect our effective tax rate to increase after the Europe accumulated losses are fully utilized. We expect that our effective tax rate in future periods may fluctuate depending on the geographic mix of our worldwide taxable income, total amount of expenses representing payments to former stockholders, losses or gains incurred by our operations in Canada and Europe, the use of accumulated losses to offset current taxable income and need for valuation allowances on certain tax assets, if any.

U.S. income and foreign withholding taxes have not been provided on undistributed earnings for certain non-U.S. subsidiaries. The undistributed earnings on a book basis for those non-U.S. subsidiaries are approximately \$2.6 million. The Company intends to reinvest these earnings indefinitely in its operations outside the U.S. If the undistributed earnings are remitted to the U.S. these amounts would be taxable in the U.S. at the current federal and state tax rates net of foreign tax credits. Also, depending on the jurisdiction any distribution may be subject to withholding taxes at rates applicable for that jurisdiction.

We file income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. We are subject to U.S. federal and certain state tax examinations for years after 2008 and are subject to California tax examinations for years after 2004. Our 2009 and 2010 federal income tax returns are currently under examination, including the impact of the sale of Asia Pacific business segment in 2009. We believe that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations, although we cannot assure you that this will be the case given the inherent uncertainties in these examinations.

### North America

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
	(In thousands)		(In thousands)		
Revenues	\$26,209	\$25,147	\$86,368	\$82,415	
Income from operations	\$2,506	\$3,121	\$13,888	\$18,094	
Income from operations as a % of revenues	9.6	% 12.4	% 16.1	% 22.0	%

North America net revenues increased \$1.1 million for the three months ended September 30, 2013 from the three months ended September 30, 2012 (see "Revenues" above). North America expenses increased \$1.8 million for the three months ended September 30, 2013 from the three months ended September 30, 2012. This increase was primarily due to a \$1.8 million increase in salary and employee related expenses from an increase in headcount.

North America net revenues increased \$4.0 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012 (see "Revenues" above). North America expenses increased \$8.4 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. This increase was primarily due to a \$6.6 million increase in salary and employee related expense resulting from an increase in headcount.





## Europe

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
	(In thousands)		(In thousands)		
Revenues	\$11,047	\$10,300	\$34,391	\$31,725	
Income from operations	\$1,469	\$1,074	\$5,916	\$6,038	
Income from operations as a % of revenues	13.3	% 10.4	% 17.2	% 19.0	%

Europe net revenues increased \$747,000 for the three months ended September 30, 2013 from the three months ended September 30, 2012 (see “Revenues” above). Europe expenses increased \$452,000 for the three months ended September 30, 2013 from the three months ended September 30, 2012. This increase was primarily due to a \$570,000 increase in salary and employee related expense resulting from an increase in headcount.

Foreign currency movements relative to the U.S. dollar negatively impacted our income from our operations in Europe by approximately \$31,000 for the three months ended September 30, 2013. Foreign currency movements relative to the U.S. dollar negatively impacted our income from our operations in Europe by approximately \$546,000 for the three months ended September 30, 2012.

Europe net revenues increased \$2.7 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012 (see “Revenues” above). Europe expenses increased \$3.2 million for the nine months ended September 30, 2013 from the nine months ended September 30, 2012. This increase was primarily due to a \$2.1 million increase in salary and employee related expense resulting from an increase in headcount and a \$778,000 increase in cost of revenue primarily related to Local Deals and Getaways credit card fees and customer service. Foreign currency movements relative to the U.S. dollar negatively impacted our income from our operations in Europe by approximately \$102,000 for the nine months ended September 30, 2013. Foreign currency movements relative to the U.S. dollar negatively impacted our income from our operations in Europe by approximately \$1.4 million for the nine months ended September 30, 2012.

## Liquidity and Capital Resources

As of September 30, 2013, we had \$77.9 million in cash and cash equivalents, of which \$41.9 million was held outside the U.S. in certain of our foreign operations. If these assets are distributed to the U.S., we may be subject to additional U.S. taxes in certain circumstances. Cash and cash equivalents increased from \$61.2 million as of December 31, 2012 primarily as a result of cash provided by operating activities, offset by cash used in investing activities as explained below. We expect that cash on hand will be sufficient to provide for working capital needs for at least the next 12 months.

	Nine Months Ended September 30,	
	2013	2012
	(In thousands)	
Net cash provided by operating activities	\$18,665	\$23,689
Net cash used in investing activities	(1,810)	(2,046)
Net cash provided by (used in) financing activities	—	(3,611)
Effect of exchange rate changes on cash and cash equivalents	(124)	858
Net increase in cash and cash equivalents	\$16,731	\$18,890

Net cash provided by operating activities is net income adjusted for certain non-cash items and changes in assets and liabilities. Net cash provided by operating activities for the nine months ended September 30, 2013 decreased by \$5.0 million compared to the nine months ended September 30, 2012. The \$5.0 million decrease in cash provided by

operating activities was due primarily to a \$22.7 million decrease in net income, a \$2.2 million decrease in accounts payable, \$2.2 million decrease in accrued expenses, offset by a \$19.0 million increase in unexchanged promotional shares accrual, a \$1.9 million increase in income tax receivable and payable and a \$963,000 increase in accounts receivable.

Net cash used in investing activities was \$1.8 million for the nine months ended September 30, 2013 compared to \$2.0 million for the nine months ended September 30, 2012. The \$236,000 decrease in cash used in investing activities was due primarily to a \$1.8 million release of restricted cash, offset by a \$1.6 increase in purchases of property and equipment.

On April 21, 2011, the Company entered into an agreement which required a \$20.0 million cash payment to the State of Delaware resolving all claims relating to the State of Delaware's unclaimed property review, which related primarily to unexchanged promotional shares contingency.

Since March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged promotional shares, which were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3.0 million charge related to this unexchanged promotional shares contingency.

In October 2013, the Company entered into agreements with 34 additional states to resolve those states' claims related to similar unclaimed property audits. The multi-state settlement relates to approximately 700,000 additional shares of the Company which could have been issued to residents of those states in the merger, which those states claim are subject to escheat. While the Company disputes the states' claims, the Company determined that it was in its best interest to resolve the disputes and settle with 34 of the states.

An additional 15 states remain that have or may raise claims on approximately 400,000 additional shares that were not claimed following the merger by residents in those states. The Company expects to make one-time cash payments to the 34 states after further due diligence, which it intends to make from cash on hand.

To cover those payments, as well as potential future settlements with the remaining 15 states, the Company recorded a \$22.0 million charge, during the three months ended September 30, 2013. The Company intends to make such payments from cash on hand. The payments to the states covered by the multi-state settlement are to be made following completion of further due diligence procedures, which are underway.

The ultimate resolution of this matter with the remaining states may take longer than one year; however, we have included the estimated loss for these remaining states potential claims in our reserves. The total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws, including whether penalties and interest are applicable.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfy the condition to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. See Note 1 to the condensed consolidated financial statements for further details.

Our capital requirements depend on a number of factors, including market acceptance of our products and services, the amount of our resources we devote to the development of new products, cash payments to former stockholders of Travelzoo.com Corporation, expansion of our operations, and the amount of resources we devote to promoting awareness of the Travelzoo and Fly.com brands. Since the inception of the program under which we make cash payments to people who establish that they were former stockholders of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period, we have incurred expenses of \$2.9 million. While future payments for this program are expected to decrease, the total cost of this program is still undeterminable because it is dependent on our stock price and on the number of valid requests ultimately received. In addition, we do not know if the current unclaimed property audits that are focused on the unexchanged promotional shares will result in additional payments to states or former stockholders of Travelzoo.com Corporation.

Consistent with our growth, we have experienced substantial increases in our cost of revenues, sales and marketing expenses and our general and administrative expenses, including increases in product development costs, and we anticipate that these increases will continue for the foreseeable future. We believe cash on hand will be sufficient to pay such costs for at least the next twelve months. In addition, we will continue to evaluate possible investments in businesses, products and technologies, the consummation of any of which would increase our capital requirements. Although we currently believe that we have sufficient capital resources to meet our anticipated working capital and capital expenditure requirements for at least the next twelve months, unanticipated events and opportunities or a less

favorable than expected development of our business in Europe with one or more of advertising formats 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.

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

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

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

The following summarizes our principal contractual commitments as of September 30, 2013 (in thousands):

	2013	2014	2015	2016	2017	Thereafter	Total
Operating leases	\$ 1,425	\$ 4,841	\$ 4,601	\$ 4,072	\$ 3,530	\$ 14,595	\$ 33,064
Purchase obligations	270	688	205	17	—	—	1,180
Total commitments	\$ 1,695	\$ 5,529	\$ 4,806	\$ 4,089	\$ 3,530	\$ 14,595	\$ 34,244

We also have contingencies related to net unrecognized tax benefits of approximately \$9.4 million as of September 30, 2013. We are unable to make reasonably reliable estimates on the timing of the cash settlements with the respective taxing authorities.

#### Critical Accounting Policies

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

#### Revenue Recognition

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

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

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

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



Collection is deemed reasonably assured. We conduct a credit review for all transactions at the time of the arrangement to determine the creditworthiness of the advertiser. Collection is deemed reasonably assured if we expect that the advertiser will be able to pay amounts under the arrangement as payments become due. If we determine that collection is not reasonably assured, then we defer the revenue and recognize the revenue upon cash collection.

Collection is deemed not reasonably assured when an advertiser is perceived to be in financial distress, which may be evidenced by weak industry conditions, a bankruptcy filing, or previously billed amounts that are past due.

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

We started selling vouchers for local businesses such as spas, hotels and restaurants using our Local Deals product in the third quarter 2010 and our Getaways products in the second quarter 2011. The Company earns a fee for acting as an agent in these transactions which is recorded on a net basis and is included in revenue upon completion of the voucher sale. Certain merchant contracts in foreign locations allow us to retain fees related to vouchers sold that are not redeemed by purchasers upon expiration, which we recognize as revenue after the expiration of the redemption period and after there are no further obligations to provide funds to merchants, subscribers or others.

#### Reserve for Subscriber Refunds

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

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

#### Allowance for Doubtful Accounts

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

#### Income Taxes

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



Our effective tax rates have differed from the statutory rate primarily due to the tax impact of foreign operations, state taxes, certain benefits realized related to stock option activities, research and experimentation tax credits, the extent that our earnings are indefinitely reinvested outside the U.S. and tax asset valuation allowance determinations including on certain loss carryforwards. For the nine months ended September 30, 2013 and 2012, our effective tax rates were (351)% and 32%, respectively. Our future effective tax rates could be materially impacted by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, changes in the deferred tax assets or liabilities, changes in tax asset valuation allowance determinations including the valuation allowance on our European loss carryforwards, changes in our judgment about whether certain foreign earnings are indefinitely reinvested outside the U.S., or changes in tax laws, regulations, and accounting principles. In addition, we are subject to the continuous examination of our income tax returns by the IRS and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

#### Loss Contingencies

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

#### RISK FACTORS

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

#### Risks Related to Our Financial Condition and Business Model

We cannot assure you that we will be profitable.

For the nine months ended September 30, 2013, we incurred a loss of \$8.2 million. For the nine months ended September 30, 2012, we generated a net income of \$14.4 million. In the years ended December 31, 2012 and 2011, we generated a net income of \$18.2 million and \$3.3 million, respectively. Although we were profitable in 2012 and 2011, there is no assurance that we will continue to be profitable in the future. We forecast our future expense levels based on our operating plans and our estimates of future revenues. We may find it necessary to significantly accelerate expenditures relating to our sales and marketing efforts or otherwise increase our financial commitment to creating and maintaining brand awareness among Internet users and advertisers. If our revenues grow at a slower rate than we anticipate, or if our spending levels exceed our expectations or cannot be adjusted to reflect slower revenue growth, we may not generate sufficient revenues to be profitable. Any of these developments could result in a significant decrease in the trading price of our common stock.

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

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

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mismatches between resource allocation and client demand due to difficulties in predicting client demand in a new market;  
• changes in general economic conditions that could affect marketing efforts generally and online marketing efforts in particular;

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- the magnitude and timing of marketing initiatives, including our acquisition of new subscribers and our expansion efforts in other regions;
- the introduction, development, timing, competitive pricing and market acceptance of our products and services and those of our competitors;
- our ability to attract and retain key personnel;
- our ability to manage our planned growth;
- our ability to attract users to our websites, which may be adversely affected by the audience shift to mobile devices;
- technical difficulties or system downtime affecting the Internet generally or the operation of our products and services specifically;
- payments which we may make to previous stockholders of Travelzoo.com Corporation who failed to submit requests for shares in Travelzoo Inc. within the required time period, or escheat claims related to shares not issued in the Company's merger with Travelzoo.com Corporation; and
- volatility of our operating results in new markets.

We may significantly increase our operating expenses related to advertising campaigns for the Travelzoo and Fly.com brands for a certain period if we see a unique opportunity for a brand marketing campaign, if we find it necessary to respond to increased brand marketing by a competitor, or if we decide to accelerate our acquisition of new subscribers. If revenues fall below our expectations in any quarter and we are unable to quickly reduce our operating expenses in response, our operating results would be lower than expected and our stock price may fall.

Our expansion of our product offering to include Local Deals and Getaways formats and the addition of a hotel booking platform may result in additional costs that exceed revenue and may trigger additional stock volatility. During the third quarter of 2010, we launched our Local Deals format of advertising and during the second quarter of 2011, we launched our Getaways format of advertising, under which we sell vouchers directly to consumers to advertise promotional deals provided by merchants. For example, a consumer could buy a voucher for \$99 for a dinner for two at a merchant's restaurant that would normally be valued at \$199, representing a promotional value of \$100 to the consumer. This format will require investments to maintain and grow the business including additional sales force hiring, building a customer service organization, marketing, technology tracking systems and payment processing. This format, introduced to the market in recent years, has resulted in many competitors entering the marketplace, thereby creating a very competitive marketplace. This competitive landscape along with the required investments to start, maintain and grow this format creates a risk that our costs may exceed our revenues in the short and long term, which may materially impact our results of operations and financial condition. Operating this format may introduce additional volatility to our stock price due to the performance of this format by the Company and/or the overall market valuations that are being determined by the market for companies operating this format of advertising. In addition, our plan to add a hotel booking platform may result in an increase in costs to develop the platform in the near-term and an increase in cost structure in the long-term, which may be in excess of incremental revenue generated by the platform.

Recent trends in consumer adoption and use of mobile devices create new challenges.

Widespread adoption of mobile devices, such as the iPhone, Android-enabled smart phones, and tablets such as the iPad, coupled with the improved web browsing functionality and development of thousands of useful “apps” available on these devices, is driving substantial traffic and commerce activity to mobile platforms. We have experienced a significant shift of business to mobile platforms and our advertising partners are also seeing a rapid shift of traffic to mobile platforms. Our major competitors and certain new market entrants are offering mobile applications for travel products and other functionality, including proprietary last-minute discounts for hotel bookings. Advertising and distribution opportunities may be more limited on mobile devices given their smaller screen sizes. The gross profit earned on a mobile transaction may be less than that earned from a typical desktop transaction due to different consumer purchasing patterns. For example, hotel reservations made on a mobile device typically are for shorter lengths of stay and are not made as far in advance as hotel reservations made on desktop. Further, given the device sizes and technical limitations of tablets and smartphones, mobile consumers may not be willing to download multiple applications from multiple travel service providers and instead prefer to use one or a limited number of applications for their mobile travel activity. As a result, the consumer experience with mobile applications, as well as brand recognition and loyalty, are likely to become increasingly important. We have made progress creating mobile offerings which have received strong reviews and have shown solid download trends. We believe that mobile bookings present an opportunity for growth. Further development of our mobile offerings is necessary to maintain and grow our business as consumers increasingly turn to mobile devices instead of a personal computer and to mobile applications instead of a web browser. Further, many consumers use a mobile device based web browser instead of an application. As a result, it is increasingly important for us to develop and maintain effective mobile websites optimized for mobile devices to provide customers with appealing easy-to-use mobile website functionality. If we are unable to continue to rapidly innovate and create new, user-friendly and differentiated mobile offerings and efficiently and effectively advertise and distribute on these platforms, or if our mobile applications are not downloaded and used by travel consumers, we could lose market share to existing competitors or new entrants and our future growth and results of operations could be adversely affected.

We may have exposure to additional tax liabilities.

As an international company providing online advertising services, we are subject to income taxes as well as non-income based taxes, in both the U.S. and various foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes and other tax liabilities. Although we believe that our tax estimates are reasonable, there is no assurance that the final determination of tax audits or tax disputes will not be different from what is reflected in our historical income tax provisions and accruals. Changes in tax laws or tax rulings may have a significantly adverse impact on our effective tax rate.

We are also subject to non-income based taxes, such as value-added, payroll, sales, use, net worth, property and goods and services taxes, in both the U.S. and various foreign jurisdictions. From time to time, we are under audit by tax authorities with respect to these non-income based taxes and may have exposure to additional non-income based tax liabilities. The Company's 2009 and 2010 federal income returns are currently under examination, including the impact of the sale of Asia Pacific business segment in 2009.

Adverse application of state and local tax laws could have an adverse effect on our business and results of operation. Our expansion of our product offering to include a hotel booking platform may subject us to state and local tax laws and result in additional tax liabilities. A number of jurisdictions in the U.S. have initiated lawsuits against other online travel companies, related to, among other things, the payment of hotel occupancy and other taxes (i.e., state and local sales tax). In addition, a number of municipalities have initiated audit proceedings, issued proposed tax assessments or started inquiries relating to the payment of hotel occupancy and other taxes.

To the extent that any tax authority succeeds in asserting that we have a tax collection responsibility, or we determine that we have one, with respect to future transactions, we may collect any such additional tax obligation from our customers, which would have the effect of increasing the cost of hotel room reservations to our customers and, consequently, could make our hotel service less competitive (i.e., versus the websites of other online travel companies

or hotel company websites) and reduce hotel reservation transactions; alternatively, we could choose to reduce the compensation for our services on "merchant" hotel transactions. Either step could have a material adverse effect on our business and results of operations. We will continue to assess the risks of the potential financial impact of additional tax exposure, and to the extent appropriate, we will reserve for those estimates of liabilities.

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

Our current revenue model depends primarily on advertising fees paid by travel and entertainment companies. If current clients decide not to continue advertising their offers with us and we are unable to replace them with new clients, our business may be adversely affected. To be successful, we must provide online marketing solutions that achieve broad market acceptance by travel and entertainment companies. In addition, we must attract sufficient Internet users with attractive demographic characteristics to our products. It is possible that we will be required to further adapt our business model and products in response to changes in the online advertising market or if our current business model is not successful. For example, the trend toward mobile online traffic will require us to adapt our product offering to facilitate consumers use our products. If we do not adapt to this trend fully or quickly enough, we may lose advertising revenue as consumer usage may decline from our non-mobile traffic. If we are not able to anticipate changes in the online advertising market or if our business model is not successful, our business could be materially adversely affected.

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

We depend on our ability to attract and retain advertisers (hotels, spas, restaurants, vacation packagers, airlines, etc.) that are prepared to offer products or services on compelling terms to our subscribers. We do not have long-term arrangements to guarantee the availability of deals that offer attractive quality, value and variety to consumers or favorable payment terms to us. We must continue to attract and retain advertisers in order to increase revenue and maintain profitability. If new advertisers do not find our marketing and promotional services effective, or if existing advertisers do not believe that utilizing our products provides them with a long-term increase in customers, revenue or profit, they may stop making offers through our marketplace. In addition, we may experience attrition in our advertisers in the ordinary course of business resulting from several factors, including losses to competitors and advertiser closures or bankruptcies. If we are unable to attract new advertisers in numbers sufficient to grow our business, or if too many advertisers are unwilling to offer products or services with compelling terms to our subscribers or offer favorable payment terms to us, we may sell less advertising, and our operating results will be adversely affected. For example, we may lose advertisers due to market conditions or performance, such as our recent loss of revenue from certain online booking engines, airlines and vacation packagers. We may not add enough additional revenue, such as hotel revenue from Getaways or the planned hotel booking platform, in order to replace the lost revenue. Furthermore, the new revenue may cost more to generate compared to the costs that the lost revenue required to generate, thereby adversely impacting our operating results.

Our existing advertisers may shift from one advertising service to another, which may adversely affect our revenue. Existing advertisers may shift from one advertising service (e.g. Top 20) to another (e.g. Local Deals and Getaways). These shifts between advertising services by advertisers could result in no incremental revenue or less revenue than in previous periods depending on the amount purchased by the advertisers, and in particular with Local Deals and Getaways, depending on how many vouchers are purchased by subscribers. In addition, we are anticipating a shift from our existing hotel revenue to commission-based revenue as we obtain the hotel booking platform capabilities, which may result in lower revenue depending on volume of hotel bookings.

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

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

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



If our advertisers do not meet the needs and expectations of our subscribers, our business could suffer. Our business depends on our reputation for providing high-quality deals, and our brand and reputation may be harmed by actions taken by advertisers that are outside our control. In particular, this is the case with our Local Deals and Getaways merchants, since we are selling vouchers on behalf of the merchants, directly to our subscribers as opposed to the remainder of our business in which we are only collecting the advertising fee from the advertiser and the subscribers are booking the deal directly with the advertiser. Any shortcomings of one or more of our merchants, particularly with respect to an issue affecting the quality of the deal offered or the products or services sold, may be attributed by our subscribers to us, thus damaging our reputation and brand value and potentially affecting our results of operations. In addition, negative publicity and subscriber sentiment generated as a result of fraudulent or deceptive conduct by our merchants could damage our reputation, reduce our ability to attract new subscribers or retain our current subscribers, and diminish the value of our brand.

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

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

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

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

For the nine months ended September 30, 2013, our cash and cash equivalents increased by \$16.7 million to \$77.9 million, of which \$41.9 million was held outside the U.S. We intend to continue to grow our business and fund our current operations using cash on hand. However, this may not be sufficient to meet our needs, including the payments required under settlements relating to escheat claims, as described under Note 1 above. We may not be able to obtain financing on commercially reasonable terms, or at all.

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



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

Our business may be sensitive to recessions.

The demand for online advertising may be linked to the level of economic activity and employment in the U.S. and abroad. Specifically, our business is primarily dependent on the demand for online advertising from travel and entertainment companies. The recent recession decreased consumer travel and caused travel and entertainment companies to reduce or postpone their marketing spending generally, and their online marketing spending in particular. Continued or future recessions could have a material adverse effect on our business and financial condition. Our operations could be significantly hindered by the occurrence of a natural disaster or other catastrophic event. Our operations are susceptible to outages due to fire, floods, power loss, telecommunications failures, unexpected technical problems in the systems that power our websites and distribute our e-mail newsletters, break-ins and similar events. In addition, a significant portion of our network infrastructure is located in Northern California, an area susceptible to earthquakes. We do not have multiple site capacity to protect us against any such occurrence. Outages could cause significant interruptions of our service. In addition, despite our implementation of network security measures, our servers are vulnerable to computer viruses, physical and electronic break-ins, and similar disruptions from unauthorized tampering with our computer systems. We do not carry business interruption insurance to compensate us for losses that may occur as a result of any of these events.

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

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

We are subject to payments-related risks.

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

**Risks Related to Our Markets and Strategy**

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

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

Although our revenues in Europe increased 8.0% in the nine months ended September 30, 2013 from the same period last year and our operations in Europe generated a profit of \$4.0 million for the nine months ending September 30, 2013 and a profit of \$7.6 million during the 2012 fiscal year, our operations in Europe incurred a loss of \$1.8 million during the 2010 fiscal year, primarily as a result of significant expenses related to subscriber acquisition and the launch of Fly.com. We intend to continue adding a significant number of subscribers in selected countries in which we operate as we believe this is one of the factors that will allow us to increase our advertising rates and increase our revenues in Europe.

If we incur losses from our operations in Europe in the future, these losses may not have any recognizable tax benefit. We expect that this would have a material negative impact on our net income and cash flows. Any of these developments could result in a significant decrease in the trading price of our common stock. In addition to

uncertainty about our ability to generate net income from our foreign operations and expand our international market position, there are certain risks inherent in doing business internationally, including:

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- trade barriers and changes in trade regulations;
- difficulties in developing, staffing and simultaneously managing foreign operations as a result of distance, language and cultural differences;
- stringent local labor laws and regulations;
- currency exchange rate fluctuations;
- risks related to government regulation; and
- potentially adverse tax consequences.

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

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

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

If we fail to retain our existing subscribers or acquire new subscribers, our revenue and business will be harmed. We spent \$4.3 million and \$6.0 million on online marketing initiatives relating to subscriber acquisition for the nine months ended September 30, 2013 and 2012, respectively, and expect to continue to spend significant amounts to acquire additional subscribers. We must continue to retain and acquire subscribers in order to maintain or increase revenue. We cannot assure you that the revenue from subscribers we acquire will ultimately exceed the cost of acquiring new subscribers. If subscribers do not perceive our offers to be of high value and quality or if we fail to introduce new and more relevant deals, we may not be able to acquire or retain subscribers. If we reduce our subscriber acquisition costs, we cannot assure you that this will not adversely impact our ability to acquire new subscribers. If we are unable to acquire new subscribers who purchase our deals directly or indirectly in numbers sufficient to grow our business, or if subscribers cease to purchase our deals directly or indirectly through our advertisers, the revenue we generate may decrease and our operating results will be adversely affected. If the level of usage by our subscriber base declines or does not grow as expected, we may suffer a decline in subscriber growth or revenue. A significant decrease in the level of usage or subscriber growth would have an adverse effect on our business, financial condition and results of operations. In addition, a shift of our audience to mobile devices and social media channels without corresponding updates of our offerings or marketing activities to address this audience could result in lower revenues.

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

Events like the Middle East conflicts or the terrorist attacks on the U.S. in 2001 or the recent global financial crisis have a negative impact on the travel industry. We are not in a position to evaluate the net effect of these circumstances on our business. In the longer term, our business might be negatively affected by financial pressures on the travel industry. However, our business may also benefit if travel companies increase their efforts to promote special offers or other marketing programs. If such events result in a long-term negative impact on the travel industry, such impact could have a material adverse effect on our business.

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

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



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

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

- rapidly changing technology in online advertising, including a significant shift of business to mobile platforms;
- evolving industry standards, including both formal and de facto standards relating to online advertising;
- developments and changes relating to the Internet;
- competing products and services that offer increased functionality; and
- changes in travel company, entertainment company, and Internet user requirements.

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

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

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

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

Since the commencement of our operations, we have experienced a period of rapid growth. In order to execute our business plan, we must continue to grow significantly. As of September 30, 2013, we had 448 employees, up from 407 employees as of September 30, 2012. We expect that the number of our employees will continue to increase for the foreseeable future. This growth has placed, and our anticipated future growth will continue to place, a significant strain on our management, systems, and resources. We expect that we will need to continue to improve our financial and managerial controls and reporting systems and procedures. We will also need to continue to expand and maintain close coordination among our sales, production, marketing, IT, and finance departments. We may not succeed in these efforts. Our inability to expand our operations in an efficient manner could cause our expenses to grow disproportionately to revenues, our revenues to decline or grow more slowly than expected and could otherwise have a material adverse effect on our business.

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

We compete for advertising dollars with large Internet portal sites, such as MSN and Yahoo!, that offer listings or other advertising opportunities to travel, entertainment and local businesses. These companies have significantly greater financial, technical, marketing and other resources and larger advertiser bases. We compete with search engines like Google and Bing that offer pay-per-click listings. We compete with travel metasearch engines like Kayak Software Corp. and online travel and entertainment deal publishers. We compete with large online travel agencies like Expedia and Priceline that also offer advertising placements and capture consumer interest. We compete with companies like Groupon and LivingSocial that sell vouchers for deals from local businesses such as spas, hotels and restaurants. We expect to face increased competition from other Internet and technology-based businesses such as Google and Microsoft, each of which has launched initiatives which are directly competitive to our Local Deals and Getaways products. Google has introduced their hotel search product which negatively impacted our ability to efficiently purchase Google hotel search traffic to drive our Search product revenues. We also have seen that some competitors will accept lower margins, or negative margins, to attract attention and acquire new subscribers. If competitors engage in group buying initiatives in which merchants receive a higher percentage of the face value than we currently offer, we may be forced to pay a higher percentage of the face value than we currently offer, which may reduce our revenue. In addition, we compete with newspapers, magazines and other traditional media companies that operate websites which provide online advertising opportunities. We expect to face additional competition as other established and emerging companies, including print media companies, enter the online advertising market.

Competition could result in reduced margins on our services, loss of market share or less use of Travelzoo by advertisers and consumers. If we are not able to compete effectively with current or future competitors as a result of these and other factors, our business could be materially adversely affected.

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

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

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

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

Acquisitions, investments and joint ventures could result in operating difficulties, dilution, and other harmful consequences that may adversely impact our business and results of operations.

We may evaluate and consider a wide array of potential strategic transactions as part of our overall business strategy, including business combinations, acquisitions and dispositions of businesses, technologies, services, and other assets, as well as strategic investments and joint ventures. At any given time we may be engaged in discussions or negotiations with respect to one or more of these types of transactions. Any of these transactions could be material to our financial condition and results of operations.

These transactions involve significant challenges and risks. Some of the areas where we may face risks or difficulties include:

• Diversion of management time and focus from operating our business to acquisition integration challenges.

• Implementation or remediation of controls, procedures, and policies at the acquired company.

• Integration of the acquired company's accounting, human resource, and other administrative systems, and coordination of product, engineering, and sales and marketing functions.

• Transition of operations, users, and customers onto our existing platforms.

Failure to obtain required approvals on a timely basis, if at all, from governmental authorities, or conditions placed upon approval, under competition and antitrust laws which could, among other things, delay or prevent us from completing a transaction, or otherwise restrict our ability to realize the expected financial or strategic goals of an acquisition.

• In the case of foreign acquisitions, the need to integrate operations across different cultures and languages and to address the particular economic, currency, political, and regulatory risks associated with specific countries.

• Failure to successfully further develop the acquired business or technology.

• Cultural challenges associated with integrating employees from the acquired company into our organization, and retention of employees from the businesses we acquire.





Liability for activities of the acquired company before the acquisition, including patent and trademark infringement claims, violations of laws, commercial disputes, tax liabilities, and other known and unknown liabilities.

Litigation or other claims in connection with the acquired company, including claims from terminated employees, customers, former stockholders, or other third parties.

- Challenges relating to the structure of an investment, such as governance, accountability and decision-making conflicts that may arise in the context of a joint venture.

Expected and unexpected costs incurred in pursuing acquisitions, including identifying and performing due diligence on potential acquisition targets that may or may not be successful.

Entrance into markets in which we have no direct prior experience and increased complexity in our business.

Inability to sell disposed assets.

Impairment of goodwill and other assets acquired or divested.

Our failure to address these risks or other problems encountered in connection with our past or future acquisitions and investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities, and harm our business generally.

Future acquisitions may also require us to issue additional equity securities, spend our cash, or incur debt (and increased interest expense), liabilities and amortization expenses related to intangible assets or write-offs of goodwill, which could adversely affect our results of operations and dilute the economic and voting rights of our stockholders. Also, the anticipated benefit of many of our acquisitions may not materialize.

#### Risks Related to the Market for our Shares

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

The trading price of our common stock has been and may continue to be subject to wide fluctuations. During the twelve months ended October 23, 2013, the closing price of our common stock on the NASDAQ Global Select Market ranged from \$16.74 to \$32.68. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results; announcements of technological innovations or new products by us or our competitors; changes in financial estimates and recommendations by securities analysts; the operating and stock price performance of other companies that investors may deem comparable to us; and news reports relating to trends in our markets or general economic conditions.

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

Ralph Bartel, who founded Travelzoo and who is a Director of the Company is the sole beneficiary of the Ralph Bartel 2005 Trust, which is the controlling shareholder of Azzurro Capital Inc. As of September 30, 2013, Azzurro is the Company's largest stockholder, holding approximately 47.1% of the Company's outstanding shares. Through his beneficial ownership, Ralph Bartel is in a position to effectively control Travelzoo and to elect our entire board of directors.

#### Risks Related to Legal Uncertainty

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

Shareholder lawsuits for securities violations are often launched against companies whose stock price is volatile. Such lawsuits involving the Company would require management's attention to defend, which may distract attention from operating the Company. In addition, the Company may incur substantial costs to defend itself and/or settle such claims, which may be considered advisable to minimize the distraction and costs of defense. Such lawsuits would result in judgments against the Company requiring substantial payments to claimants. Such costs may materially impact our results of operations and financial condition. Between August 2011 and January 2012, numerous class action and derivative lawsuits were filed against the Company. See further disclosure in Note 5 to the condensed consolidated financial statements included in this report.

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

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

- user privacy;
- anti-spam legislation;
- consumer protection;
- copyright, trademark and patent infringement;
- pricing controls;
- characteristics and quality of products and services;
- sales and other taxes; and
- other claims based on the nature and content of Internet materials.

The implementation of the CARD Act and similar state and foreign laws may harm our Local Deals business. Vouchers which are issued under our Local Deals and Getaways may be considered gift cards, gift certificates, stored value cards or prepaid cards and therefore governed by, among other laws, the Credit CARD Act of 2009 (the "CARD Act"), and state laws governing gift cards, stored value cards and coupons. Other foreign jurisdictions have similar laws in place, in particular European jurisdictions where the European E-Money Directive regulates the business of electronic money institutions. Many of these laws contain provisions governing the use of gift cards, gift certificates, stored value cards or prepaid cards, including specific disclosure requirements and prohibitions or limitations on the use of expiration dates and the imposition of certain fees. For example, if the vouchers are subject to the CARD Act and are not included in the exemption for promotional programs, it is possible that the purchase value, which is the amount equal to the price paid for the voucher, or the promotional value, which is the add-on value of the voucher in excess of the price paid, or both, may not expire before the later of (i) five years after the date on which the voucher was issued; (ii) the voucher's stated expiration date (if any); or (iii) a later date provided by applicable state law. Purported class actions against other companies have been filed in federal and state court claiming that coupons similar to the vouchers are subject to the CARD Act and various state laws governing gift cards and that the defendants have violated these laws by issuing the coupons with expiration dates and other restrictions. In addition, investigations by certain state attorney general offices have been launched against other companies with regards to similar issues. If similar claims are asserted against the Company in respect of the Local Deals and Getaway vouchers and are successful, we may become subject to fines and penalties and incur additional costs. In addition, if federal or state laws require that the face value of our vouchers have a minimum expiration period beyond the period desired by a merchant for its promotional program, or no expiration period, this may affect the willingness of merchants to issue vouchers in jurisdictions where these laws apply. For unredeemed vouchers, similar laws in other jurisdictions require us or merchants to honor the face value of vouchers sold, after the redemption period. For example, in Germany, certain consumer protection laws require us to refund consumers for almost four years after the purchase date for the amount of the face value of purchased vouchers which remains unredeemed at the end of the redemption period. Therefore, we do not recognize the unredeemed amounts as revenue until after we are not subject to these laws. There may be similar laws in other countries or provinces that require similar practices. Such developments may materially and adversely affect the profitability or viability of our Local Deals and Getaways. If we are required to materially increase the estimated liability recorded in our financial statements with respect to unredeemed Local Deals and Getaways vouchers due to application of certain gift card laws, our net income could be materially and adversely affected. In certain states and foreign jurisdictions, our Local Deals and Getaways vouchers may be considered a gift card. Some of these states and foreign jurisdictions include gift cards under their unclaimed and abandoned property laws which require companies to remit to the government the value of the unredeemed balance on the gift cards after a specified period of time (generally between one and five years) and impose certain reporting and recordkeeping obligations. We do not remit any amounts relating to unredeemed vouchers we sell based on our assessment of applicable laws. The analysis of the potential application of the unclaimed and abandoned property laws to our vouchers is complex, involving an analysis of constitutional and statutory provisions and factual issues, including our relationship with subscribers and merchants and our role as it relates to the issuance and delivery of a voucher. In the event that one or more states or foreign jurisdictions successfully challenges our position on the application of its unclaimed and abandoned property laws to vouchers, or if the estimates that we use in projecting the likelihood of vouchers being redeemed prove to be inaccurate, our liabilities with respect to unredeemed vouchers may be materially higher than the amounts shown in our financial statements. If we are required to materially increase the estimated liability recorded in our financial statements with respect to unredeemed gift cards, our net income could be materially and adversely affected. Moreover, a successful challenge to our position could subject us to penalties or interest on unreported and unremitted sums, and any such penalties or interest would have a further material adverse impact on our net income. New tax treatment of companies engaged in Internet commerce may adversely affect the commercial use of our services and our financial results.

Due to the global nature of the Internet, it is possible that various states or foreign countries might attempt to regulate our transmissions or levy sales, income or other taxes relating to our activities. Tax authorities at the international, federal, state and local levels are currently reviewing the appropriate treatment of companies engaged in Internet commerce. New or revised international, federal, state or local tax regulations may subject us or our subscribers to additional sales, income and other taxes. We cannot predict the effect of current attempts to impose sales, income or other taxes on commerce over the Internet. New or revised taxes and, in particular, sales taxes, VAT and similar taxes would likely increase the cost of doing business online and decrease the attractiveness of advertising and selling goods and services over the Internet. New taxes could also create significant increases in internal costs necessary to capture data, and collect and remit taxes. Any of these events could have an adverse effect on our business and results of operations.

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

We may be sued for defamation, civil rights infringement, negligence, patent, copyright or trademark infringement, invasion of privacy, personal injury, product liability, breach of contract, unfair competition, discrimination, antitrust or other legal claims relating to information that is published or made available on our websites or service offerings we make available (including provision of an application programming interface platform for third parties to access our website, mobile device services and geolocation applications). These types of claims have been brought, sometimes successfully, against online services in the past. The fact that we distribute information via e-mail may subject us to potential risks, such as liabilities or claims resulting from unsolicited e-mail or spamming, lost or misdirected messages, security breaches, illegal or fraudulent use of e-mail or interruptions or delays in e-mail service. These risks are enhanced in certain jurisdictions outside the U.S., where our liability for such third-party actions may be less clear and we may be less protected. In addition, we could incur significant costs in investigating and defending such claims, even if we ultimately are not found liable. If any of these events occurs, our business could be materially and adversely affected.

We are subject to risks associated with information disseminated through our websites and applications, including consumer data, content that is produced by our editorial staff and errors or omissions related to our product offerings. Such information, whether accurate or inaccurate, may result in our being sued by our advertisers, merchants, subscribers or third parties and as a result our revenue and goodwill could be materially and adversely affected. Claims have been asserted against us relating to shares not issued in our 2002 merger.

The merger of Travelzoo.com Corporation into the Company became effective on April 25, 2002. Holders of promotional shares of Travelzoo.com Corporation who established they had satisfied certain prerequisite qualifications were allowed a period of two years following the effective date to receive one share of Travelzoo Inc. in exchange for each share of common stock of Travelzoo.com Corporation. After April 25, 2004, two years following the effective date, we ceased issuing shares to the former stockholders of Travelzoo.com Corporation. Many of the "Netsurfer stockholders," who had applied to receive promotional shares of Travelzoo.com Corporation in 1998 for no cash consideration, did not elect to receive their shares which were issuable in the merger prior to the end of the two-year period. A total of 4,115,532 of our shares which had been reserved for issuance in the merger were not claimed.

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

Since March 2012, the Company has become subject to unclaimed property reviews by most of the other states in the U.S. that relate primarily to the unexchanged promotional shares which remained unexchanged in the 2002 merger and were not covered by the settlement and release by the State of Delaware. During the three months ended March 31, 2012, the Company recorded a \$3.0 million charge related to this unexchanged promotional shares contingency.

In October 2013, the Company entered into agreements with 34 additional states to resolve those states' claims related to similar unclaimed property audits. The multi-state settlement relates to approximately 700,000 additional shares of the Company which could have been issued to residents of those states in the merger, which those states claim are subject to escheat. While the Company disputes the states' claims, the Company determined that it was in its best interest to resolve the disputes and settle with 34 of the states.

An additional 15 states remain that have or may raise claims on approximately 400,000 additional shares that were not claimed following the merger by residents in those states. The Company expects to make one-time cash payments to the 34 states after further due diligence, which it intends to make from cash on hand.

To cover those payments, as well as potential future settlements with the remaining 15 states, the Company recorded a \$22.0 million charge, during the three months ended September 30, 2013. The Company intends to make such payments from cash on hand. The payments to the states covered by the multi-state settlement are to be made following completion of further due diligence procedures, which are underway.

The ultimate resolution of this matter with the remaining states may take longer than one year; however, we have included the estimated loss for these remaining states potential claims in our reserves. The total amount of exposure of this contingency is dependent upon the manner in which each state applies its unclaimed property laws, including whether penalties and interest are applicable.

The Company is continuing its program under which it makes cash payments to people who establish that they satisfy the conditions to receive shares of Travelzoo.com Corporation, and who failed to submit requests to convert their shares into shares of Travelzoo Inc. within the required time period. The accompanying condensed consolidated financial statements include a charge in general and administrative expenses of \$8,000 and \$22,000 for these cash payments for the three and nine months ended September 30, 2013, respectively.

The total cost of this program is not reliably estimable because it is based on the ultimate number of valid requests received and future levels of the Company's common stock price, and would be affected by any settlement of the pending reviews referred to above. The Company's common stock price affects the liability because the amount of cash payments under the program is based in part on the recent level of the stock price at the date valid requests are received. As noted above, in order to receive payment under the program, a person is required to establish that such person validly held shares in Travelzoo.com Corporation.

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

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

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

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

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

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

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



materially adversely affected.

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

We cannot be certain that our products, content and brand names do not or will not infringe valid patents, copyrights or other intellectual property rights held by third parties. While we have a trademark for "Travelzoo," many companies in the industry have similar names including the word "travel". We expect that infringement claims in our markets will increase in number as more participants enter the markets. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. We may incur substantial expenses in defending against these third party infringement claims, regardless of their merit, and such claims could result in a significant diversion of the efforts of our management personnel. Successful infringement claims against us may result in monetary liability or a material disruption in the conduct of our business. As discussed under Note 5 to the condensed consolidated financial statements included in this report, a lawsuit was recently filed against us by a non-practicing entity, commonly referred to as a "patent troll", claiming that the trip-planning Metasearch service available on Fly.com infringes one or more claims of certain asserted patents. The plaintiff has asserted similar claims against other Metasearch websites, including Expedia, Orbitz, Travelocity, Priceline, Yahoo! Inc., American Express, Kayak Software Corp. and BookIt.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Our operations in Canada expose us to foreign currency risk associated with agreements being denominated in Canadian dollars. Our operations in Europe expose us to foreign currency risk associated with agreements being denominated in British Pound Sterling and Euros. We are exposed to foreign currency risk associated with fluctuations of these currencies as the financial position and operating results of our operations in Canada and Europe are translated into U.S. dollars for consolidation purposes. We do not use derivative instruments to hedge these exposures. We are a net receiver of U.S. dollars from our foreign subsidiaries and therefore benefit from a weaker U.S. dollar and are adversely affected by a stronger U.S. dollar relative to the foreign currency used by the foreign subsidiary as its functional currency. We have performed a sensitivity analysis as of September 30, 2013, using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to the U.S. dollar with all other variables held constant. The foreign currency exchange rates we used were based on market rates in effect at September 30, 2013. The sensitivity analysis indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in an incremental \$151,000 foreign exchange loss for the nine month periods ended September 30, 2013.

#### Item 4. Controls and Procedures

For the period ended September 30, 2013, we carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer along with the Company's Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e) and 15d-15(e). Based upon that evaluation, the Company's Chief Executive Officer along with the Company's Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2013 to ensure that the information required to be disclosed by us in this quarterly report was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and were also effective to ensure that information required to be disclosed by us in this quarterly report was accumulated and communicated to our management including the Company's Chief Executive Officer and the Company's Chief Financial Officer to allow timely decisions regarding its disclosure.

During the three months ended September 30, 2013, there was no change in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.



PART II—OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

An updated description of the risk factors associated with our business is included under “Risk Factors” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contained in Item 2 of Part I of this report. This description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Item 1A of our 2012 Annual Report on Form 10-K and is incorporated herein by reference.

Item 6. Exhibits

The following table sets forth a list of exhibits:

Exhibit Number	Description
3.1	— Certificate of Incorporation of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002)
3.2	— By-laws of Travelzoo Inc. (Incorporated by reference to our Pre-Effective Amendment No. 6 to our Registration Statement on Form S-4 (File No. 333-55026), filed February 14, 2002)
10.1	— Form of Director and Officer Indemnification Agreement (Incorporated by reference to Exhibit 10.1 on Form 10-Q (File No. 000-50171), filed November 9, 2007)
10.14*	— Nonqualified Stock Option Agreement between Travelzoo Inc. and Christopher Loughlin dated July 22, 2013.
31.1‡	— Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2‡	— Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1†	— Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2†	— Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS†	XBRL Instance Document
101.SCH†	XBRL Taxonomy Extension Schema Document
101.CAL†	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF†	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB†	XBRL Taxonomy Extension Label Linkbase Document
101.PRE†	XBRL Taxonomy Extension Presentation Linkbase Document

\* This exhibit is a management contract or a compensatory plan or arrangement.

‡ Filed herewith

† Furnished herewith



SIGNATURE

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

TRAVELZOO INC.  
(Registrant)

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

Date: October 24, 2013