Off Wall Street
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New Rec: priceline.com (PCLN $110.875) June 23, 1999

Position: Sell Target: $25 Timing: 2 (1=aggressive; 5=cautious)

$000	Q1 99	Q2 99e	Q3 99e	Q4 99e	F1999e	F2000e
REVS	49,411	104,331	126,955	135,460	416,157	559,180
EPS $	(0.12)	(0.08)	(0.06)	(0.05)	(0.32)	(0.40)
Y/Y%	NM	NM	NM	NM	NM	NM
PE					NM	NM
PSR					460x	28x
Consen		(0.11)	(0.10)		(0.43)	(0.26)

Shares Out: 142 M Market Cap: $15.744 B FYE: Dec.

Summary: Priceline's business model is complicated, and is not well understood, despite the tremendous publicity afforded the company. Consumers make sealed fixed bids in a black box environment, and are awarded a ticket if they submit a winning bid. They are given minimal information in advance about the purchase and may not cancel if they win. Consumers are led to believe that they can enhance their chances of winning by agreeing to take some other product, like a credit card. In this sense, the best comparison to PCLN's model is a sweepstakes operation. PCLN's model also is similar to web businesses that sell product at or near cost in order to drive consumers to the site, where advertisers are then able to reach them.

PCLN has two sources of revenue, and it has two main deals that provide that revenue. One source of revenue is the sale of products or fees for selling a product, and the other is the revenue from "adaptive marketing" agreements. While there has been some discussion about the product sale side of the business, there has been much less discussion of the importance of the adaptive marketing side of the business.

On the product side, Delta is the main supplier, and on the adaptive marketing side, the main deal is with First USA. As we explain, below, both of these deals are heavily front-end loaded in PCLN's favor, and both appear to be designed to create the impression of very rapid growth in the early stages. However, the early benefits of both of these deals also appear to be unsustainable, as we explain, so that we think that the early favorable impression created by this artificially rapid early growth will also not be sustainable.

Because profit margins on product sales are very low, adaptive marketing is the profit cornerstone of the Priceline model. In Q1 99, for example, gross margin on airline tickets excluding those sold with adaptive marketing was "mid single digits". Overall, Q1 profit margins on travel services are negative. Nearly all the gross profit was provided by adaptive marketing. However, adaptive marketing's ability to be a big profit generator is uncertain. Priceline has made several marketing agreements to date. The first major agreement with Capital One did not last long. It called for Capital One to pay a fee for each credit card application submitted. Capital One cancelled after less than nine months. The reason was that Capital One's approval rates were only in single digits, and even on approved cards usage was low and cancellations were high, reflecting a low quality customer acquired at the priceline.com website. The second credit card agreement is with First USA. The card that is being offered is not very attractive. Performance payments are not due until the client has used the card for over one year. Even under the best of circumstances, the agreement will generate $200 million in revenue to PCLN over a five year period. However, we expect the basic problems experienced by Capital One will also be experienced by First USA. The First USA agreement is front end loaded, easily canceled or amended, and further revenue is performance based. We expect this deal to disappoint investors.

Priceline should recognize substantial up front fees from First USA for several quarters, which will impress, but will also mislead investors. The problem is that the performance hurdles Priceline has to clear are too high for the type of credit card accounts Priceline will generate. If returns on customer outstanding balances do not achieve 3%, or if First USA's customer acquisition costs are not competitive with the rest of its acquisition arrangements, First USA will be in a position where it will demand better terms or cancel. We think that both of these hurdles will prove to be too difficult for PCLN, as we explain in more detail, below, and chances of an agreement modification are high. This could conceivably happen as early as October '99, and would be a shock to investors. It is clear from this deal that, beyond the first several quarters, Priceline is at risk, but First USA is not.

Priceline's primary product is airline tickets. Bulls argue that since airlines fly at 70% capacity, filling the added 30% can be enormously profitable. This is a gross oversimplification. Airlines can't operate at 100% system capacity any more than could a steel mill. Recently, for example, on the busiest travel day in history, airlines reportedly only reached 85% capacity. Moreover, airlines seek to maximize revenue, not the number of seats sold. Airlines make a huge effort not to undermine their pricing structure.

Indeed, a close reading of Priceline's agreement with Delta, which appears to be supplying the majority of Priceline's tickets, reveals that Delta has a short term goal in supplying tickets. The terms of the deal mean that the more tickets Delta gives to Priceline in the early stages of the deal the faster it may sell its shares. Since the more tickets Priceline has to sell, the higher the stock price may go, this makes the two company's interests coincide in the short term. Amazingly, if Delta only sells about $150 million of tickets to Priceline in each of the first three years of the agreement at prices that allow Priceline to earn approximately a 12% gross margin, Delta stands to profit by $2.1 billion, at PCLN's current $111 share price. Delta will be able to exercise its options on the full amount well before the three years is up, and is subject to a call option at a later date if it does not fulfill its agreement. Delta has a tremendous incentive to hit all its supply targets as soon as possible, so that it can sell all its shares while PCLN shares are still at a high price. Longer term, however, when these tremendous incentives run out, there is good reason to think that Delta will not provide the ever increasing supply of "off- tariff" fares the "street" expects. Interestingly, Despite its supposed strategic relationship with Delta, priceline.com is not even allowed to display the Delta name.

Priceline's business model appears simple at first, but it is complicated and risky. It relies on continuous product flow, success with adaptive marketing, and a high percentage of new business in order to take advantage of the adaptive marketing model. This means high customer acquisition costs. PCLN's chances of success appear to be based on many assumptions for which the company has no basis in experience. We do not think that the financial hurdles that would allow the company to earn substantial profits on its adaptive marketing deal can be overcome. We also are skeptical about the ability of PCLN to maintain its product flow. After the initial front-end loaded results are in from both the Delta and the FirstUSA deals, which will make investors feel good, we think investors will be in for a rude awakening.

Discussion:

1. Priceline's revenue recognition method overstates revenues.

Priceline's revenue recognition accounting exaggerates its results. Priceline acts like a travel agency, matching buyers and sellers. Unlike a travel agency, Priceline books the entire ticket sales price as revenue, while a traditional agent only records the ticket commission as revenue. The distinction between the accounting treatment for commissions and gross revenue may seem subtle, but it has a dramatic impact on reported revenue. This methodology appeals to internet investors who are focused on revenues and not on gross profits. In the example below, we compare Priceline's revenue using its methodology as compared to that of a typical online travel agent, who receives the current $10 cap on airline tickets sold online.

Q1 99

	Commission	Priceline

	Method	method	% Diff.
Tickets sold (#)	186,000	186,000	--
Ticket price ($)		208.6	
Commission ($)	10		
Ticket revenue ($)	1,860,000	38,800,000	1,986%
Other revenue ($)	10,610,000	10,610,000	
Total revenue ($)	12,470,000	49,410,000	296%

Priceline would have minimal travel revenues if it recorded commissions rather than gross ticket sales as revenue. Travel agents receive approximately an 8% commission on ticket sales, with a $10 cap on tickets sold online. On the Q1 99 conference call PCLN suggested that ticket margins were in the "low single digits." We estimate that when combined with hotel room sales, travel gross margins are still negative. "Gross" bookings resulted in impressive year/year comparisons for Q1 99. A major "street" firm titled a research report on the first quarter, "548,911% Revenue Growth!" (Never mind that Priceline got into the airline ticket business in Q2 98.) What if E*Trade or Charles Schwab reported the total value of all stocks purchased as their customers as revenue, and asked investors to subsequently value the stock as a multiple of gross revenues?

2. Adaptive marketing is the major source of profits.

While the "street" positions priceline.com as a unique model for selling distressed inventory, the financial results suggest otherwise. Plane tickets and hotel rooms are being sold close to cost, and profitability is dependent on marketing activities. "Adaptive marketing" is nothing more than offering customers perceived discounts in return for applying for a credit card or another product. Priceline then gets paid by receiving fees from the soliciting company. Customers try to "win" a cheap plane ticket, and Priceline tries to make money by selling credit cards, magazine subscriptions and pre-paid calling cards. This is similar to other internet companies who sell product at cost, but get revenue from advertising, since they are supposed to be driving traffic with low prices.

We estimate that Priceline's gross profit is generated from adaptive marketing and not from tickets or hotel rooms. Adaptive marketing revenue in Q1 99 was said to be "greater than 10% of total revenues" in the 10-Q. We have estimated Q1 99 hotel and marketing revenues using management guidance that 87% of Q1 99 revenue was travel, and 10-Q disclosure that revenue from plane tickets was $38.8 million.

Revenue and margin estimate, excluding warrant costs

	6/98	9/98	12/98	3/99
Air travel revenue	$7,031	$8,513	$14,856	$38,800
Hotel room revenue	0	0	837	4,187
Cost of goods sold – air	7,952	8,842	15,602	38,159
Cost of goods sold – hotel	0	0	1,099	5,500
Gross profit on travel	(921)	(329)	(1,009)	(672)
Adaptive marketing	0	700	3,300	6,423
Reported gross margin	(921)	371	2,291	5,751
Gross Profit				
On travel	-13.1%	-3.9%	-6.4%	-1.6%
After adaptive marketing	-13.1%	4.0%	12.1%	11.6%

"Street" analysts estimate that Priceline's product margins will eventually increase to 15% by 2001. However, a 15% level of gross profit is inconsistent with the supposed "distressed" nature of the products being sold. Airline analysts estimate that participating carriers are selling tickets to Priceline at a 5%-10% discount to standard pricing. Priceline uses the Worldspan CRS, so Priceline must still pay booking fees just like a traditional travel agent. Assuming carriers do give Priceline a 10% discount means that Priceline would only be offering a 2.6% average discount to consumers to meet the "street's" estimate of 15% margins. We think this is inconsistent with the discount consumers are seeking from Priceline, and they wouldn't "buy it" at that price.

Illustration of the problem with "street" product margin projection of 15%:

	Tariff	Margin	PCLN	Margin	Discount
Ticket sales price	100.0		97.4		2.6%
Commission	8.0	8%	14.6	15%	
Net to carrier	92.0		82.8		10.0%

3. There may be a limited supply of lucrative adaptive marketing programs.

Additional adaptive marketing revenue requires new customer flow, or a multitude of high-paying marketing programs. But Priceline only has one high-paying marketing program, and additional programs appear unlikely. Because of its dependence on this approach, repeat customers appear to have little value to priceline.com. Currently, the website offers customers three "bonus money" discounts. Although these discounts are referred to as adaptive marketing they look like a sweepstakes contest to us. For agreeing to take an offering, you increase your chance to "win" a ticket.

Current Adaptive Marketing Offerings

$40	For a no fee First USA Visa card
$5	For subscribing to Arthur Frommer's Budget Travel magazine. (You subscribe for six issues for $14.95 and get two free issues, and will be billed after 4 months if you don't cancel.)
$5	For accepting 20 free minutes on a pre-paid calling card. (You can continue to use the card after your 20 minutes runs out and pay the card's current rates (not given).

Customers select the First USA card because Priceline tells them it will substantially increase their chance of winning a ticket at their specified price. The $5 from the other offers hardly seem to be worth the trouble. Since PCLN only gets paid once per customer credit application, the $40 in "free bonus money" is only offered the first time that the customer bids. If the bidder is unsuccessful, he/she will not have the bonus available in future attempts to purchase a ticket or hotel room. The website clearly reads:

"Bonus money will not be added if you have previously applied for a First USA Visa through Priceline."

For this reason, repeat customers do not generate adaptive marketing revenue and appear to be even less likely to win a ticket at their price, unless they are offering close to a market price. The mechanics of adaptive marketing "work" because Priceline collects fees on all completed credit card applications but only a small percent of consumers bidding at below market prices actually buy a ticket. Of 1.4 million tickets requested, only 186,250 were sold, for a fulfillment rate of 13%. Fees from multiple applications are being used to discount one ticket sold. This is hardly a customer value proposition, although the consumers do not realize it. More interestingly, since adaptive marketing only captures value from new customers, it should not increase proportionately with total site traffic.

4. Customer acquisition costs are high, product gross margins are low, and adaptive marketing must save the day.

Customer acquisition costs

	6/98	9/98	12/98	3/99
Marketing expense/ticket sold	$212.50	$189.00	$123.19	$92.02
Q/Q %		-11.1%	-34.8%	-25.3%
Marketing expense/ticket bid	$21.77	$17.42	$17.90	$18.23
Q/Q %		-20.0%	2.8%	1.8%
Marketing expense/new bidder	$31.55	$28.79	$29.74	$32.26
Q/Q %		-8.8%	3.3%	8.5%

The high level of marketing required to sustain the company's model raises doubts about its eventual profitability. We estimate that Q1 99 gross profit per ticket sold was about $3.

Gross margin/Ticket

	6/98	9/98	12/98	3/99
Price/ticket sold	$230	$230	$215	$208
Cost/ticket sold	260	239	227	205
Loss/ticket sold	($30)	($9)	($12)	$3

Priceline is spending $92 in marketing per ticket sold to get $3 in gross profit. Although this trend is improving, we estimate that marketing expense per ticket sold will drop only to about $40 by the end of 1999, despite our above consensus revenue estimate. We think gross profit per ticket sold might increase to about $10 by the end of 1999, still resulting in a $30 gap between product gross profit and marketing expense.

As a result, adaptive marketing revenue is the key to the success of the priceline.com model.

5. The First USA deal is heavily front-end loaded and is likely to disappoint.

Capital One canceled its agreement with Priceline on March 3, 1999, effective May 1, 1999. Capital One withdrew from the agreement because it was not as profitable as it had hoped. Although priceline.com was able to generate applications, the vast majority of the applications were poor quality and could not be approved. As a result, Capital One's approval rate was in the single digits. Moreover, those that could be offered a credit card proved to be unprofitable due to low usage or high cancellation rates. These are the same problems that will come back to haunt Priceline in its First USA agreement.

Priceline quickly signed a new agreement with First USA. Near term, we think the First USA deal will look good for Priceline, but longer term, the deal will pose problems. In effect, First USA is guaranteeing Priceline good near term financial results in exchange for the ability to renegotiate all the terms of the agreement at a later date. A reading of the "Interactive marketing agreement" included at the back of the March 10-Q provides a good understanding of the First USA relationship. Priceline trumpets it as a 5 year, $200 million agreement, but no explanation is provided as to how the $200 million is calculated. Industry sources indicate this must be a very aggressive reading of the agreement. Below, is a summary of our interpretation of the key terms;

<u>Terms of adaptive marketing agreement:</u>

A. Agreement Targets:

* 5 year ROO (average return on average outstandings) to be greater than or equal to 3%;
* NPV/CPA (net present value/cost per account) to be equal to or greater than First USA's other competitive opportunities;

B. 5 Year agreement with a one year initial term and 2 two year renewal terms.

C. If agreement targets are not being met after one year, then the agreement will either be modified at any time thereafter on a basis satisfactory to First USA "FUSA" to achieve targets on prospective accounts, or the agreement may be canceled.

D. "Account Origination Fee" (unspecified amount) to be paid for every account opened, with at least one statement sent with a balance due.

However, if these accounts result in "nominal" business (small balances, balances paid in full, or no use for three months) and the targets are not being met and are there is no improvement within 90 days, then these fees will be modified going forward. If the changes are not mutually agreed upon, then FUSA has the right to terminate.

E. Application volume. If Priceline generates a specified number of account applications per quarter, but FUSA does not approve at least 50%, then FUSA will pay Priceline a "minimum fee", calculated as if 50% of applications had been approved.

If application volume is below target for 2 quarters, or if the ROO falls below 3% then FUSA has the right to cancel the minimum fee. But, if the minimum fee is canceled, then FUSA loses its preferred position with Priceline.

F. Bonus payment for every account that results in a balance transfer, but the bonus is not payable unless at least 40% of new accounts result in balance transfers. Additional payments for account retention and account re-activations.

G. "Value Added" payments. Payment for every approved Account application, regardless if the credit card is used. Payable in lieu of the usage fee for the first 12 billing cycles.

However, Value Added payments are payable for the first 5 million accounts opened. If after 1 million accounts are opened and if the valued added payments result in a ROO less than 3%, or a NPV/CPA that is not consistent with FUSA's other offerings, then FUSA may pay the "usage fee" instead of the value added fee, for the remaining 4 million accounts.

H. Usage fee of 0.50% of net retail purchases if purchases are less than $1,000 per quarter. Undisclosed fee if purchases are greater than $1,000 per quarter. Usage fees are not payable until after the account has been opened 12 months.

Summary: The key issues to understand are that the return on average outstanding balances (ROO) must be greater than or equal to 3% on a consistent basis, and the return on customer acquisition costs, as measured by the NPV/CPA ratio (Net present value/cost per account) must be consistent with the rest of First USA's current opportunities. If the return falls below 3%, Priceline's compensation will decrease, and vice versa**.** These targets compare with industry pre-tax returns of 2.5% and after-tax returns of about 1.5% on average balances outstanding. First USA is not at risk, and requires that the Priceline deal pay for itself.

The problem is that the majority of credit card customers generated through priceline.com in particular and the internet in general are low quality, and below First USA's standards. This was why Capital One canceled, and we do see any reason why priceline.com's customer quality should improve. Online card applications are disproportionately from people who have poor credit histories, since everyone else receives weekly offers for a new credit card through the mail. According to industry sources, while off-line approval rates are above 80%, online approval rates are less than 10%.

It is surprising that First USA could win this business away from Capital One since Capital One specializes in sub-prime accounts and First USA does not. Why did Priceline accept the First USA deal and not renegotiate with Capital One? The FUSA agreement calls for First USA to pay "minimum fees" for application volume. Even if First USA approves less than 50% of applicants, FUSA will still pay Priceline a "minimum fee" equal to the amount that would have been payable if 50% of applications had been approved. We think this 50% guarantee will result in acquisition cost per account being too high, and the terms will have to be adjusted downwards. This will negatively impact Y2000 adaptive marketing revenues. We think Priceline made this agreement in order to front-end load revenues in 1999**.**

We estimate that few priceline.com customers will be able to qualify for the 9.99% First USA card, and those that will qualify may not use it. Although the APR is 9.99%, there is no low "introductory" rate for either purchases or balance transfers. First USA is promoting its e.Card, and other co-branded cards, all over the internet. The e.Card card has a 3.9% introductory rate for 5 months, the same 9.99% APR, and also pays 5% cash back from selected online merchants including Amazon.com, eToys.com, and ValueAmerica.com. Nextcard is also beginning to promote its own 2.9% introductory APR, or a fixed 9.99% card. Customers can have any picture they like put on the card. The card also earns reward points for frequent flier miles.

First USA's current internet activities make the new agreement even less attractive. First USA has 57 million current card holders, and is the #1 credit card marketer through direct mailings and online. First USA estimates that it does 99% of all credit card advertising on the internet. In addition, First USA recently signed an exclusive marketing deal with America Online, as well as with all of the other leading "portals" and 20 leading web-sites, including OnSale, CDNow, and Sportsline. Even with all these internet relationships First USA generated only 350,000 accounts through the internet in 1998 and it is forecasting only 1 million new accounts through the internet in 1999.

The "street" estimates that this agreement will be immensely profitable. In 2001, adaptive marketing revenue is forecasted to be about $50 million. We estimate this translates into 2 million active credit card customers, a number we think is wildly optimistic. As a point of comparison, First USA opened about 350,000 accounts through all of its internet marketing programs in 1998, half of which (175,000) were generated from its agreement with America Online. AOL ended 1998 with 15 million customers. The minimum fee payable to PCLN as if

50% of accounts were being approved should create a high cost per acquired FUSA account. We think Priceline's future fees will decrease dramatically once First USA aligns the cost per acquired account back in line with the rest of its internet marketing business.

6. Other adaptive marketing opportunities are limited.

First USA's exclusive position may also make similar credit card deals unlikely, and worth substantially less. For instance, Priceline can offer other credit cards to those who have been rejected by First USA, or have rejected a First USA offer twice. The presence of a second card would also interfere with Priceline's efforts to increase First USA usage. Offers for magazines and calling cards only credit customers with $5, a less attractive promotion than the $40 discount received for a credit card application. Without the additional marketing revenue to boost up the ticket price, Priceline's value proposition loses most of its appeal.

Relationships with other financial institutions like E*Trade are discussed by the "street" as if the program is still active, but the E*Trade agreement existed only for the IPO. Priceline allocated 500,000 shares to E*Trade. This stock was for priceline.com customers (who opened a E*Trade account, after bidding for a ticket, of course). Priceline received a $75 fee from E*Trade for every funded account. However, a link to the E*Trade website was removed from priceline.com prior to the IPO after a reporter questioned the legality of Priceline advertising its IPO. Furthermore, we do not see the synergy between customers seeking discounted plane tickets and opening brokerage accounts. E*Trade already gives customers a $75 credit if they send in the minimum required to open an account.

7. Estimates of the size of the airline ticket opportunity are exaggerated.

The argument that since 30% of seats on major US carriers currently fly empty then Priceline must be addressing a $25+ billion market opportunity is obviously flawed. Moreover, discount, or off-tariff fares, is not a new concept. These types of tickets are widely available for international travel through ticket consolidators. Domestic off-tariff tickets are generally restricted for use in tour packages, and travel agencies are prohibited from selling the tickets on a stand-alone basis. How prevalent are off-tariff fares? Cheap Tickets, another online travel site and one of the largest ticket consolidators, claims to offer 400,000 non-published fares, and 45 million published fares, suggesting that discount tickets represent less than 1% of available tickets.

Non-tour domestic discount tickets are predominantly TWA flights connecting through St. Louis. Industry observers claim that TWA discounts due to its poor yield management skills, and a 1995 ticket supply agreement signed with a Carl Icahn company, that allows him to purchase a specified amount of TWA tickets per year at 40% to 55% of the published rate. TWA is the least profitable of the major airlines and its load factor is near the industry average.

8. Airlines seek to maximize revenues, not tickets sold.

Airlines continuously change fares according to demand forecasting programs in response to actual ticket sales. Airlines create different "buckets" such as the 14-day advance purchase requirement and Saturday stay requirement, to separate leisure travelers from business travelers. This has resulted in an industry where roughly 6% of the passengers account for 37% of the revenues. Despite the frustration these fare changes cause last-minute travelers, much of the airlines profitability has been credited to the use of revenue management. In this light, Priceline is asking airlines to expand the "bucket" at the discount end, to sell more seats on flights that are not full.

Will the expansion of this low end "bucket" appeal to airline management? The major airlines increased total revenues only 4.1% from 1997 to 1998 despite a strong economy and ticket price increases. Airlines have also sought out other techniques to boost load factors, such as code sharing, that do not result in discounting. Airlines are currently more interested in raising leisure fares than lowering them, and are now in the midst of attempting their third price increase this year. Load factors are near historical highs and airlines have little incentive to discount.

9. Delta and Northwest agreement.

Delta signed a participation agreement with the company on August 31, 1999, which was followed by an agreement with Northwest on October 2. Industry observers claim Delta's involvement with Priceline was driven by its slow development of its own website, and its lagging efforts in yield management. While the "street" views the Delta agreement as a validation of the priceline.com model, the agreement gives Delta control over many parts of the business. In addition to receiving warrants for 12.5% of the company, Delta also received important concessions including:

(a) Control over which airlines are included in the priceline.com service;
(b) Requires more than 90% of all PCLN tickets to include a Saturday night stay;
(c) Right to an independent license to Priceline software if a major airline offers a competitive service;
(d) First right to fulfill Priceline tickets on specified routes;
(e) Detailed information of all customer offers not fulfilled.
(f) "Kickbacks" to Delta if sales of Delta tickets result in a 12% or higher gross margin;

The return of some part of "excess" gross profits over 12% limits Priceline's ticket margins. Instead of being a revolutionary business model, Priceline's Delta ticket margins appear to be contractually limited to about 12%-15%, in line with other discount travel sites like Cheap Tickets, and only slightly higher than current domestic commission rates of 8%.

Delta also inserted key defensive information into the contract, which prohibits Priceline from selling competitor's tickets in Delta's key markets. From Delta's agreement, presented in the S-1;

"Priceline agrees that it will not issue tickets (i) on [*omitted*] in the following markets: (x) to or from ATL, BOS, DFW, CVG, and SLC (the "Delta Key Markets"), except for offers originating from MSP, DTW and MEM or O&D markets not served by Delta or a carrier operating a flight under Delta's two letter ("DL") designator code and (y) to, from or in the State of Florida, except for flights from MSP, DTW or MEM or O&D markets not served by Delta…"

Through this contract, Delta effectively blocks competitors on Delta routes from selling tickets through priceline.com. Interestingly, Delta excluded Northwest's "hubs" (MSP, DTW, MEM) from the contract, as if to encourage Northwest to join Priceline. We note that Northwest and Delta have few competing routes. Encouraging Northwest to join also has the added benefit of lining Delta's pockets, as we discuss, below.

10. The Delta warrant agreement encourages short term allocation of tickets.

If Priceline were such a threat to airline pricing, how do we explain Delta and Northwest's participation, and the recent surge in PCLN's ticket sales? First, Priceline is forfeiting its own commissions to pass that savings on to customers, while earning its gross profit on adaptive marketing. Second, Priceline loaded its airline partners with warrants to encourage ticket allocations. Delta received warrants for 18.62 million shares at $0.93, and three airlines each received warrants for 312,500 shares at $3.20 and another airline received warrants for 1.25 million shares at $6.40. Together, at a current share price of $111, this represents a combined profit of over $2.2 billion, or about 15% of the combined market capitalizations of the four domestic airlines who participate in the service. Now, that's incentive. As we discuss, below, we think the recent surge in ticket volume may reflect Delta's efforts to quickly profit from its Priceline warrants, but may not mean a long term relationship.

In mid May, Priceline published a series of press releases indicating that "street" revenue estimates were too low. The three successive releases stated that priceline.com had surpassed the 5,000, 6,000 and 7,000 tickets sold in a single day within three weeks. This prompted a major "street" analyst to think that revenues for Q2 99 could be greater than $100 million, significantly higher than his published estimate of $66 million. Only at the beginning of January had Priceline crossed the 1,000 tickets/day milestone. Where are all these tickets coming from?

The Delta participation warrant agreement, included at the back of the February 16, 1999 S-1/A outlines Delta's release schedule. In summary, the first 50% of Delta's 18.9 million shares in Priceline will be released if Delta sells $61 million in tickets through Priceline in calendar 1999. The second 50% will also be released in 1999 if Delta sells an additional $87 million in tickets, and if Priceline earns a specified margin on those tickets. Delta can release all $2.1 billion of its stock if Delta distributes just $148 million of tickets through Priceline in 1999. This is less than 1% of Delta's 1998 revenues, and may have no impact on profits because Delta would have paid another intermediary, anyway.

The agreement encourages Delta to hit its milestones in the first year because each measurement period is "separate not cumulative", meaning Delta would have to re-achieve certain ticket levels in the second year (or later years), in order to release additional warrants.

Delta release schedule of Priceline warrants:

	Tickets Sold ($MM)	After Northwest ($MM)	Cumulative warrants % Released	Cum. Percent	Total PCLN shares
Base Amount:	30.0		-	-	-
	35.0		10%	10%	1,888,260
	40.0		10%	20%	3,776,521
	45.0		10%	30%	5,664,781
	50.0		10%	40%	7,553,041
Threshold 1:	72.5	61.0	10%	50%	9,441,302
Threshold 2:	185.0	148.0	50%	100%	18,882,603

The agreement has two interesting twists. First, if another domestic carrier with at least 5% market share subsequently enters into an agreement with Priceline then Delta's "thresholds" would be adjusted downwards. This stipulation explains Delta's strong interest in recruiting Northwest into the Priceline service, which happened in October 98. The $22.5 MM increment necessary to get from 40% to 50% was reduced to $11 MM, and the $72.5 MM threshold needed to release the second 50% of warrants can be reduced to about $35 MM. After the $35 million hurdle is cleared, Priceline needs to sell $112.5 million in tickets at a specified margin, for total sales of $148 million, to release all its stock. The formula that reduces Delta's hurdle is shown below.

$$\frac{\text{Delta market share}}{\text{Delta market share + new carrier market share +other participants}} = \frac{\text{Delta 16.6\%}}{\text{Delta 16.6\% + NWA 10.7\%+TWA 3.9\% +AW 2.6\%}} = 0.49$$

By helping to recruit Northwest, Delta lowered its requirement to "hit" the first threshold by $11.5 million and its second threshold by $37.0 million.

Second, the contract gives Priceline a "call" on some of Delta's stock at the exercise price in the event that ticket volume decreases from year one to year two, and from year two to year three. However, the call is only applicable to the second 50% of Delta's stock, and under no circumstances is the first 50% callable, once released. The amount of stock callable is to be calculated by taking the difference between what was actually earned, and what would have been earned if the two year total was divided equally between the two years. The calls for years 2 and 3 work in a similar fashion.

The presence of the calls might initially suggest that Delta would spread its ticket volume over three years. However, the warrants are not subjected to a three year lock-up period. The lock up ends when the targets are hit. This obviously creates an incentive for Delta to hit the targets as quickly as possible, while the stock price is still high, and then to sell shares. In order to keep the proceeds, Delta must equal the year one sales in years two and three in order to avoid the call. This is a very clever arrangement for Priceline, and a great deal for Delta if PCLN shares hold up for a while.

Despite Delta's potential $2.1 billion gain on its Priceline warrants, Delta's stock has actually declined about 15% since the PCLN IPO**,** for a decrease in its market value of about $1.6 billion. The strong stock price performance of PCLN since its IPO has amazed Delta management and gives Delta the incentive to release its shares now, and to sell as early as possible. Although both Delta and Priceline recently suggested Delta's warrants would be released within 12 months, we think at least 40% of Delta's stock will be released by the end of Q2 99, and the balance by the end of the year. Delta has to simply meet its previous year's revenue totals for two years to avoid the call. It is important to note, however, that Delta has little incentive to grow the business to over $150 million per year.

11. Why priceline.com is not a value proposition for other airlines.

Almost all major airlines now offer promotional fares from their websites and via e-mail alerts. These last minute tickets target the same audience as priceline.com. In addition to stimulating new demand, and filling the Saturday flights that fly with low load factors, the direct offerings enhance an airline's relationship with the consumer. Customers get frequent flier miles and feel as if they got a bargain. The airline also benefits from future ticket purchases from its website, rather than through an agent. United Airlines, for instance, uses special fares on its website for travel for holiday weekends such as Mother's Day, to promote the United brand to leisure travelers. Even Delta is currently discounting many of its flights to and throughout the southeast on its own website.

Direct competition from airlines' own websites could be a challenge. Consumers are given full flight details and do not have to guess a price, whereas priceline.com is contractually restricted from displaying important flight information.

12. Similar product offering opportunities appear to be limited**.**

Bulls expect that PCLN will soon enter and revolutionize other large markets. Priceline is currently targeting hotel rooms, cars, mortgages and related financial products, and claims to be studying rental cars, cruises and additional markets. Nevertheless, of PCLN's current products only airline tickets have proven to be popular. Capitalizing on the Priceline craze, Budget Rent A Car has already announced a "name your own price" feature for their own cars. Why do companies need Priceline? We think the Priceline business model is limited, and that the company has already addressed its most attractive markets.

Priceline has released surprising little about its hotel room sales, except that since the service was introduced in October 1998 it has sold more than 75,000 room nights. In an April '99 press release, Priceline stated it was selling 5,000 room nights a week, up from 1,000 nights a week in January '99.

Although the lodging industry has the same "ideal priceline.com profile of high fixed costs and low variable costs", hotels are not subjected to the same type of competition as airlines. Hotels are aimed at specific segments of the market, and are priced accordingly. Unlike the airline industry, hotels have latitude to discount through specific travel agents if they want to increase occupancy rates by accepting lower rates, without making the discount known to all potential customers.

Importantly, hotels are not subjected to the wide variances between “full fare” and “advance purchase” that characterize air travel. Airline revenue management systems can charge higher rates for business travelers by raising the cost of the flight as the departure date approaches. Hotels, on the other hand, are more likely to discount rooms when existing reservations show occupancy rates to be below target. Unlike airlines, which can capture a high fare from a last minute business traveler, hotels lack that pricing power. This distinction makes Priceline’s system less attractive for hotel clients, especially since customers do not know which hotel they might get.

Priceline’s home mortgage and financial products are essentially an interface to LendingTree, an internet based mortgage finance lender. Priceline is responsible for consumer marketing and maintaining the mortgage service on its own website. Yet priceline.com and LendingTree.com have distinctly different business models. At LendingTree, customers submit their profiles, and the type of loan product they seek. LendingTree then allows lenders to compete for the business through a competitive auction, and the best bids are reported to the potential borrower. In contrast, Priceline appears to be forcing its “name your own price” into the LendingTree model, with no added consumer value. Customers can submit their offers to Priceline, which will then submit them to LendingTree. Why not just go to LendingTree? LendingTree currently has its own website and is seeking its own customers.

Priceline’s “demand collection system” demonstrates its limitations when applied to “non-perishable” inventory such as cars. While consumers try to “name their own price” for a specified car, the dealer is allowed to submit a counteroffer. This sounds remarkably similar to the approach other car websites like Microsoft’s Carpoint, Autobytel and Autoweb are taking. Competition for car sales online continues to intensify. New auto websites like CarsDirect.com, backed by Michael Dell, and Driveoff.com are seeking to exclude all middlemen. CarsDirect.com currently walks consumers through the entire car buying process, from researching a car to being quoted a final price, online.

13**.** Valuation and financial assumptions:

PCLN has three sources of revenue: the travel business, the credit card marketing business, and extension businesses, including cars and loans. Investors hope that PCLN can extend its “name your own price” approach to other markets, but travel services is the only business that has proven to be popular.

Travel services represent the majority of Priceline's revenues, but reported travel revenues are misleading because they reflect gross bookings. We expect Q2

99 revenues to beat the “street” estimate of $66 million, consistent with PCLN press releases about surpassing the 7,000 tickets a day milestone. Since the “street” already expects a big upside surprise, this isn’t new news. While we estimate Q2 99 revenues of $104 million, if only the gross profit on travel were recorded as revenue then total revenues would only be $11.6 million. We think the recent increases in fill rates cited by other analysts are due to Delta allocating more tickets to Priceline to gain release of its warrants. Although we expect ticket gross margins to increase to 4%, overall gross margins should fall due to the loss of the Capital One agreement. We estimate an operating loss of $13.6 million for Q2 99, better than the Q1 99 $17.6 million loss.

Looking out for the full year 1999, we estimate total revenues of $416 million, with gross profit of $52 million. We estimate that 70% of total gross profit will be from adaptive marketing activities, as higher margin Delta ticket sales are off set by lower profits on other carrier ticket sales. We project operating losses for 1999 to total $51 million, or a loss of $0.32 per share.

Placing a value on a business with no earnings in sight is difficult. The “street” expects Priceline to turn profitable in 2001. We think that travel business revenue growth will stall in 2000 as Delta slows ticket allocations. We also expect adaptive marketing revenue growth to slow or even to decrease due to poor customer quality, renegotiated agreements, and low residual fees from First USA.

Travel websites do not command nearly the value of priceline.com. Preview Travel and Cheap Tickets trade at $256 million and $675 million valuations, respectively, even though both have higher gross bookings than Priceline. The Sabre Group has an $8 billion valuation, but it owns the major reservation system that powers internet travel sites, in addition to Travelocity.com. Although some analysts suggest this is a comparable company, it is not, since its earnings are from fees from the leading reservation system, and not from internet tickets.

If Priceline travel can generate 12% gross margins in 2000 from revenue of $545 million, then this would come to $65 million in gross profit. Amazon.com trades at 37 times 2000 projected gross profit. At 37 times Y2000 gross profit projections, PCLN's travel business would be valued at $2.4 billion.

While Priceline claims that its adaptive marketing with First USA may be worth up to $200 million, we think adverse customer selection will result in low credit card acceptance rates and Priceline will only earn a fraction of the stated $200 million. Other large deals are also unlikely to be signed. Even so, we’ll award this aspect of this business a $400 million value, in case customer quality at priceline.com improves and First USA actually can make money.

Currently, the market values auto websites Autobytel and Autoweb at approximately $300-350 million. Awarding this valuation to priceline.com’s auto business is more than generous given its developmental stage and lack of demonstrated momentum.

Priceline’s mortgage and loan business is also still in development.

However, we see little value to Priceline's service since it is simply a front end for LendingTree.com. Priceline will not own the customer relationship. Even so, we'll award this business a generous $800 million valuation as well, based on the chance it might work.

These pieces sum to $3.95 billion. We'll add an additional $400 million, in case another brand extension comes along, for a total price of $4.35 billion. We think this estimate is generous. With 180 million fully diluted shares outstanding, that calculates to less than $25 per share.

14. Projections.

INC. STATEMENT	3/98	6/98	9/98	12/98
Travel revenues	9	7,031	8,506	15,650
Adaptive marketing & fees	0	0	707	3,343
Revenues	9	7,031	9,213	18,993
Cost of revenues:				
Product costs	0	7,952	8,842	16,702
Supplier warrant costs		0	0	3,029
Total cost of revenues	0	7,952	8,842	19,731
Gross profit (loss)	9	(921)	371	(738)
GP - exl. warrants	9	(921)	371	2,291
Expenses:				
Sales & marketing	1,129	6,525	7,004	8,463
G&A	1,697	3,131	2,857	3,806
Systems	1,926	3,940	3,064	2,963
Total expenses	4,753	13,596	12,925	15,232
Operating loss	(4,744)	(14,517)	(12,554)	(15,970)
Interest	50	0	0	0
Net loss	(4,694)	(14,517)	(12,554)	(15,970)
Charges	0	0	(6,800)	(57,979)
Net loss	(4,694)	(14,517)	(19,354)	(73,949)
Diluted EPS	($0.08)	($0.18)	($0.18)	($0.62)
Operating EPS	($0.08)	($0.18)	($0.12)	($0.16)
Operating shares	58,000	81,300	105,400	119,100
Weighted average shares	55,487			

PERCENT	3/98	6/98	9/98	12/98
Travel revenues	100.0%	100.0%	92.3%	82.4%
Adaptive marketing & fees	0.0%	0.0%	7.7%	17.6%
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues:				
Product costs	0.0%	113.1%	96.0%	87.9%
Supplier warrant costs	0.0%	0.0%	0.0%	15.9%
Total cost of revenues	0.0%	113.1%	96.0%	103.9%
Gross profit (loss)	N.M.	-13.1%	4.0%	-3.9%
GP - exl. warrants	N.M.	-13.1%	4.0%	12.1%
Expenses:				
Sales & marketing	N.M.	92.8%	76.0%	44.6%
G&A	N.M.	44.5%	31.0%	20.0%
Systems	N.M.	56.0%	33.3%	15.6%
Total expenses	N.M.	193.4%	140.3%	80.2%
Operating loss		-206.5%	-136.3%	-84.1%

Interest	N.M.	0.0%	0.0%	0.0%
Net loss	N.M.	-206.5%	-136.3%	-84.1%
Charges	N.M.	0.0%	-73.8%	-305.3%
Net loss	N.M.	-206.5%	-210.1%	-389.3%

INC. STATEMENT	3/99	6/99e	9/99e	12/99e
Travel revenues	42,987	96,110	117,175	124,400
Adaptive marketing & fees	6,423	8,221	9,780	11,060
Revenues	49,411	104,331	126,955	135,460
Cost of revenues:				
Product costs	43,659	92,526	110,485	115,892
Supplier warrant costs	381	388	388	388
Total cost of revenues	44,040	92,914	110,873	116,280
Gross profit (loss)	5,371	11,418	16,083	19,180
GP - exl. warrants	5,751	11,806	16,471	19,568
Expenses:				
Sales & marketing	17,138	18,500	20,000	21,500
G&A	3,667	4,200	4,300	4,400
Systems	2,184	2,300	2,500	2,700
Total expenses	22,989	25,000	26,800	28,600
Operating loss	(17,618)	(13,582)	(10,718)	(9,420)
Interest	458	1,868	1,748	1,642
Net loss	(17,160)	(11,714)	(8,970)	(7,778)
Charges	(8,354)	0	0	0
Net loss	(25,514)	(11,714)	(8,970)	(7,778)
Diluted EPS	($0.14)	($0.06)	($0.05)	($0.04)
Operating EPS	($0.12)	($0.08)	($0.06)	($0.05)
Operating shares	142,300	145,300	149,300	154,300
Weighted average shares	94,939	142,320	147,300	151,800
Fully diluted shares	179,700	185,500	187,000	190,000

PERCENT	3/99	6/99e	9/99e	12/99e
Travel revenues	87.0%	92.1%	92.3%	91.8%
Adaptive marketing & fees	13.0%	7.9%	7.7%	8.2%
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues:				
Product costs	88.4%	88.7%	87.0%	85.6%
Supplier warrant costs	0.8%	0.4%	0.3%	0.3%
Total cost of revenues	89.1%	89.1%	87.3%	85.8%
Gross profit (loss)	10.9%	10.9%	12.7%	14.2%
GP - exl. warrants	11.6%	11.3%	13.0%	14.4%
Expenses:				
Sales & marketing	34.7%	17.7%	15.8%	15.9%
G&A	7.4%	4.0%	3.4%	3.2%
Systems	4.4%	2.2%	2.0%	2.0%
Total expenses	46.5%	24.0%	21.1%	21.1%
Operating loss	-35.7%	-13.0%	-8.4%	-7.0%
Interest	0.9%	1.8%	1.4%	1.2%
Net loss	-34.7%	-11.2%	-7.1%	-5.7%
Charges	-16.9%	0.0%	0.0%	0.0%
Net loss	-51.6%	-11.2%	-7.1%	-5.7%

YEAR/YEAR	3/99	6/99e	9/99e	12/99e
Travel revenues	N.M.	1267.0%	1277.6%	694.9%
Adaptive marketing & fees	N.M.	N.M.	1283.3%	230.8%
Revenues	N.M.	1383.9%	1278.0%	613.2%
Cost of revenues:				
Product costs	N.M.	1063.6%	1149.5%	593.9%
Supplier warrant costs	N.M.	N.M.	N.M.	-87.2%
Total cost of revenues	N.M.	1068.5%	1153.9%	489.3%
Gross profit (loss)	N.M.	N.M.	4240.7%	-2699.8%
GP - exl. warrants	N.M.	N.M.	4345.4%	754.0%
Expenses:				
Sales & marketing	1417.4%	183.5%	185.6%	154.0%
G&A	116.0%	34.1%	50.5%	15.6%
Systems	13.4%	-41.6%	-18.4%	-8.9%
Total expenses	383.7%	83.9%	107.4%	87.8%
Operating loss	271.4%	-6.4%	-14.6%	-41.0%
Interest	822.2%	N.M.	N.M.	N.M.
Net loss	265.6%	-19.3%	-28.6%	-51.3%
Charges	N.M.	N.M.	-100.0%	-100.0%
Net loss	443.5%	-19.3%	-53.7%	-89.5%
Diluted EPS	N.M.	N.M.	N.M.	N.M.
Operating EPS	N.M.	N.M.	N.M.	N.M.

INC. STATEMENT	1998	1999e	2000e
Travel revenues	31,196	380,672	545,260
Adaptive marketing & fees	4,050	35,484	13,920
Revenues	35,237	416,157	559,180
Cost of revenues:			
Product costs	33,496	362,561	508,192
Supplier warrant costs	3,029	1,545	1,552
Total cost of revenues	36,525	364,106	509,744
Gross profit (loss)	(1,288)	52,051	49,436
GP - exl. warrants		53,595	50,988
Expenses:			
Sales & marketing	24,388	77,138	88,000
G&A	18,005	16,567	18,800
Systems	11,132	9,684	11,700
Total expenses	53,524	103,389	118,500
Operating loss	(54,812)	(51,338)	(69,064)
Interest	(64,779)	5,715	6,004
Net loss	(119,591)	(45,623)	(63,060)
Charges	(64,779)	(8,354)	0
Net loss	(184,370)	(53,977)	(63,060)
Diluted EPS	($2.27)	($0.29)	($0.33)
Operating EPS		($0.32)	($0.40)
Operating shares	81,200	141,614	157,809
Weighted average shares	81,231	183,571	190,000
Fully diluted shares	81,200	167,545	157,809

PERCENT	1998	1999e	2000e
Travel revenues	88.5%	91.5%	97.5%
Adaptive marketing & fees	11.5%	8.5%	2.5%
Revenues	100.0%	100.0%	100.0%
Cost of revenues:			
Product costs	95.1%	87.1%	90.9%
Supplier warrant costs	8.6%	0.4%	0.3%
Total cost of revenues	103.7%	87.5%	91.2%
Gross profit (loss)	-3.7%	12.5%	8.8%
GP - exl. warrants	0.0%	12.9%	9.1%
Expenses:			
Sales & marketing	69.2%	18.5%	15.7%
G&A	51.1%	4.0%	3.4%
Systems	31.6%	2.3%	2.1%
Total expenses	151.9%	24.8%	21.2%
Operating loss	-155.6%	-12.3%	-12.4%
Interest	-183.8%	1.4%	1.1%
Net loss	-339.4%	-11.0%	-11.3%
Charges	-183.8%	-2.0%	0.0%
Net loss	-523.2%	-13.0%	-11.3%

YEAR/YEAR	1998	1999e	2000e
Travel revenues	N.M.	1120.3%	43.2%
Adaptive marketing & fees	N.M.	776.2%	-60.8%
Revenues	N.M.	1081.0%	34.4%
Cost of revenues:			
Product costs	N.M.	982.4%	40.2%
Supplier warrant costs	N.M.	-49.0%	0.5%
Total cost of revenues	N.M.	896.9%	40.0%
Gross profit (loss)	N.M.	N.M.	-5.0%
GP - exl. warrants	N.M.	N.M.	-4.9%
Expenses:			
Sales & marketing	N.M.	216.3%	14.1%
G&A	N.M.	-8.0%	13.5%
Systems	N.M.	-13.0%	20.8%
Total expenses	N.M.	93.2%	14.6%
Operating loss	N.M.	-6.3%	34.5%
Interest	N.M.	-108.8%	5.1%
Net loss	N.M.	-61.9%	38.2%
Charges	N.M.	-87.1%	-100.0%
Net loss	N.M.	-70.7%	16.8%
Diluted EPS	N.M.	N.M.	N.M.
Operating EPS	N.M.	N.M.	N.M.