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Priceline.com (Nasdaq: PCLN)

Falling Customer Acquisition Costs and Rising EPS

Update Coverage: STRONG BUY September 3, 2000

KEY CONSIDERATIONS

- Priceline reported a net loss per share (excluding certain items) of $.01 in the second quarter of 2000.
- The company's second quarter revenue of $352.1 million is 216% higher than Priceline's revenue for the second quarter of 1999.
- The development of Hotwire creates intense competition in Priceline's primary service.
- Priceline initiated a lawsuit against Expedia, a key competitor that is strongly affiliated with Microsoft.
- The company's customer acquisition cost dropped to $10.81 per customer, a record low for Priceline.

Recent Price	$25.94
52WK Low	$22.63
52WK High	$104 1/4
P/E	N/M
P/Book	11.02
P/Sales	4.15
Market Capitalization	4,322.13 mil
Shares Outstanding	166.63 mil
Float	51.70 mil
Daily Volume (3-month Average)	3.37 mil
EPS	
1998	$-0.53
1999	$-1.05
2000E	$-0.02
Current Ratio	2.07
Total Debt to Equity	0.00
LT Debt	0.00
Total Cash	$95.43 mil

ONE-YEAR PRICE AND VOLUME GRAPH

COMPANY PROFILE

Priceline.com employs an innovative demand-driven e-commerce system that allows consumers to name their own price on a variety of goods. Currently, Priceline allows consumers to name their own price on airline tickets, hotel reservations, new car purchases, home mortgages, used goods sold by consumers, and groceries. The company aims to bring consumers the lowest possible price by selling the excess inventory of its participating vendors and through adaptative marketing alliances with other companies (such marketing programs allow other merchants to target the Priceline customer base in exchange for increasing the customer's bid on certain items). While Priceline is currently reports high losses, the company expects to become profitable some time in 2001. Additional information about the company and its products can be obtained at its web site, www.priceline.com.

This report was prepared by Simit Patel and David R. Rivas, Ph.D.

THE COMPANY

In spite of a wavering price and skepticism among many investors, Priceline continued to experience phenomenal growth in the second quarter of 2000. The company added 1.5 million customers, tying the previous quarter's record for the largest customer increase in a single quarter for Priceline. The substantial increase in the size of the customer base was perhaps the reason the company reported a net loss of just $.01 per share, its best ever EPS.

In accordance with its business plan, the company continued to expand its product line and inventory capacity. Priceline added 3 new airline carriers to its plane ticket service and 2 new rental car providers – Hertz and Alamo -- in the second quarter of 2000, thus ensuring its ability to cope with rapid growth. The second quarter of 2000 also marked a time during which Priceline added a variety of innovative services, the most notable addition being a new product offering for travel insurance. Priceline also plans to initiate operations of its highly promoted automobile gasoline service via the WebHouse Club in the third quarter of 2000. In addition, the company plans to offer "Name Your Own Price" automobile insurance starting in early 2001. Priceline is also currently planning an expansion of its core "Name Your Own Price" business model to other areas of e-commerce, including business-to-business, cruises and vacation packages. Priceline's business-to-business service currently consists primarily of a marketing alliance with American Express, whereby AMEX's small business customers will receive access to Priceline's services.

Priceline.com continued to expand its presence in foreign markets in this past quarter. During the quarter, priceline.com and General Atlantic Partners announced the creation of Priceline.com Europe, with plans to launch its business in the fall. The companies also announced that Dennis Malamatinas, CEO of Burger King, was hired to join Priceline.com Europe as CEO. Timothy Brier, former President of Priceline Travel Services, was named as Chairman of the new company. Priceline.com President Daniel H. Schulman took on the additional title of CEO while Richard S. Braddock continues to serve as Chairman of the Company.

INDUSTRY OUTLOOK AND COMPETITION

While Priceline continues to grow at a rapid rate and approach profitability, its stock price continues to drop and behave in an inexplicably erratic manner. Furthermore, the competition in the nearly all the industries in which Priceline participates intensified significantly in the second quarter. If the competition continues to grow with such ferocity and Priceline's stock is unable to rebound, the company may find itself in a dangerous quandary.

The most important development in Priceline's competitive landscape came during the middle of the second quarter, when several of the nation's largest airline services announced a joint venture to create Hotwire, an Internet service that would directly compete with Priceline for airline ticket sales to consumers. The announcement of Hotwire scared investors to the point where Priceline's stock fell 15% in a single day. While nearly all analysts (including those at InternetFundManager) have claimed that Priceline will be able to effectively compete with Hotwire, the stock's price has failed to gain any significant value. Considering that Priceline still depends on airline ticket sales for nearly 85% of its revenue, the potential success of Hotwire could be a crucial blow to the company's financial position.

Priceline also filed a lawsuit against Expedia, another key competitor in the online plane ticket industry, in the second quarter of 2000. Expedia has already in the midst of change and confusion due to the forced break up of its parent company Microsoft, which was found to be in violation of domestic antitrust laws. Priceline claims that Expedia infringes the company's U.S. Patent 6,085,169 by operating the "Hotel Price Matcher" and "Flight Price Matcher" services. In the lawsuit, Priceline seeks declaratory relief, permanent injunctive relief, and actual and punitive damages. The potential success of this lawsuit, in conjunction with the pending fragmentation of Microsoft, may significantly weaken Expedia.

In the mortgage, consumer-to-consumer, automobile, and grocery industries, the competitive landscape for Priceline essentially remains the same. Ebay, with over 10 million registered users, still has a clear dominance of the used product marketplace. The online mortgage industry continues to prosper, but

Mortgage.com still has the largest market share. Autobytel's alliance with AutoTradeCenter.com, and the recent proliferation of numerous automobile-oriented web sites creates a highly competitive arena for the online car sales industry. In the grocery industry, however, Priceline clearly has the largest market share and continues to acquire additional customers through its alliance with WebHouse Club.

Priceline's newer services, however, are far more unique, and the environment is far less competitive for these products. Travel insurance is not a product that experiences intense competition among aspiring enterprises. Like its predecessor, the WebHouse Grocery Card, Priceline's WebHouse Gasoline Card is extremely unique, and has a virtual monopoly of sorts in the online market for the sale of gasoline. And while the Internet business-to-business market is far from empty, Priceline's unique approach regarding phone services targeted to small businesses via its alliance with American Express provides the company with a highly unique competitive advantage.

In spite of the fact that Priceline participates in several extremely competitive sectors, the company still managed to increase its revenue across the board. Priceline reported revenue totals of $352.1 million for the second quarter of 2000, a 216% increase over the revenue reported for the second quarter of 1999. The company also reported lower losses per share, and appears poised to reach profitability by the fourth quarter of 2000. In spite of operating in some of the most competitive industries in e-commerce, we believe that Priceline is well-situated and will be capable of maintaining growth in the near future.

STRATEGIES FOR GROWTH

Priceline's strategy for growth has essentially remained the same. The strategy entails horizontally expanding their product line -- thus allowing them to increase their revenue -- offering a wide variety of products and/or services, and building a loyal customer base. Thus far, this strategy appears to be successful; the percentage of repeat customers is up to 39%, up from 25% a year ago. Furthermore, Media Metrix ranked Priceline as the most recognized e-commerce site on the Internet (tied with Amazon.com). These statistics, in conjunction with the fact that the company's new customer acquisition cost has dropped to just $10.81 per customer, proves that the strategy currently being employed by management is successful.

In order to ensure that customer loyalty continues to increase, Priceline will continue to expand its product line. In the near future, the company plans to expand its product line to include leisure travel products such as cruises; time shares and vacation packages; credit cards; and automobile and personal insurance in addition to other financial services products.

The implementation of Priceline's strategy is dependent largely in part on the company's ability to secure and maintain key alliances. In the second quarter of 2000, Priceline established an alliance with General Atlantic Partners, LLC, whereby both companies would undergo a joint venture to create Priceline.com Europe – the European version of Priceline that is expected to begin operations in the fourth quarter of 2000. Priceline also announced a joint venture with a wholly owned subsidiary of the prestigious Softbank Corp. that will allow the company to introduce its e-commerce platform to the Japanese market. Priceline also opted to assume a greater equity stake in MyPrice Ltd., the Australian licensee of Priceline's unique business model. In a more domestic effort, the company spearheaded its unique long distance phone call service through various alliances with Net2Phone -- the company's anchor IP telephony provider – deltathree.com, and ZeroPlus.com.

We believe that Priceline's strategy for growth involves establishing customer loyalty and the development of a brand name through the creation of a unique and valuable product line that is established through various alliances. Priceline's strategy also calls for the company to aggressively expand into foreign markets. We believe that this strategy is suitable and will ultimately lead the company towards profitability.

RISKS

The risks associated with Priceline's strategy appear to remain the same. Namely, these risks include the following:

- Priceline still depends upon the airline ticket sales for the majority of its revenue, and thus is dependent upon the well-being of the airline industry and its ability to maintain a significant market share. The advent of Hotwire increases the likelihood of this risk becoming a reality.
- Priceline is dependent upon the continued usage and increasing prominence of the Internet.
- Priceline is dependent upon maintaining patents that are crucial to the uniqueness of its business model. Priceline is aggressively protecting its patents; this is evidenced by the company's initiation of patent infringement lawsuit against Expedia, a key competitor.
- Priceline is dependent upon the maintenance of key alliances it has established, and the ability to create new alliances in order to successfully expand its product line. Since the company's inception in 1997, it has not experienced any significant difficulties in establishing or maintaining such alliances.

FINANCIALS

Gross Profit. We believe that Priceline's gross margin will continue to improve in the future. The company's revenues have increased dramatically over the last year, and the consistently increasing number of customers and repeat customers indicate that the company's business model and strategy for growth are operating as intended. Given Priceline's improving performance over the past quarter, we expect the company's gross margin to continue to improve significantly. Furthermore, we suspect that company may reach profitability as early as the final quarter of 2000.

Research & Development. Priceline's venture into foreign markets, expanding product line, and its need to improve its computer systems in order to effectively cope with rapid growth lead us to believe that the company will spend a considerable amount of its funds towards product development and system enhancement. Still, we believe that gross revenue will increase at a faster rate; as a result, the margin will decrease.

Sales & Marketing. Priceline is still in the midst of its first national advertising campaign. In addition, the company's expanding product line and entrance into foreign markets will cause the company to increase its marketing expenditures significantly. But since the company's cost of new customer acquisition is so low, we believe that revenue will outgrow marketing expenses. We believe that the majority of the company's expenses will also have decreasing margins.

Net Income. Net income has been negative since Priceline's inception, but the company has continued to gradually approach profitability. As Priceline continues to expand its customer base at a rapid rate that is economically efficient, enjoys a large percentage of repeat customers, and offers a wide and growing product line, we believe that profitability is inevitable. We expect Priceline to earn a profit for the fiscal year 2001.

VALUATION

Investment Opinion

We believe that Priceline is highly undervalued. The company has already successfully demonstrated that its strategy is one that will lead the company towards profitability; its operations as the most recognized e-commerce site, its extremely large and loyal customer base, and its rapidly expanding product line prove that the company is capable of cross promoting various products to its customers. Its ability to acquire customers at an average price of under $11 offers statistical evidence of the successfulness of Priceline's strategy. Most importantly, revenue is growing at a phenomenal rate, and earnings per share are improving with each passing quarter.

While competition is certainly intensifying at a dangerous rate for Priceline, we believe that the company has already successfully established its brand name, strategy, and revenue model. As a result, we believe that Priceline will continue to stay on its path towards profitability, and will successfully expand its product line in accordance with the company business plan. Because of this, we feel that Priceline's plummeting stock prices in the aftermarket is an inaccurate representation of the company's true value.

For the aforementioned reasons, we now give Priceline.com a STRONG BUY rating.

Comparative Valuations of E-commerce Companies

Company (SYMBOL)	Price-to-Sales Ratio (P/S)	Gross Margin (%)
1800Flowers.com (FLWS)	.90	38.35
Amazon.com (AMZN)	6.48	19.35
Ebay (EBAY)	54.83	72.43
Egghead.com (EGGS)	.20	5.31
Priceline.com (PCLN)	4.15	20.00

INCOME STATEMENT	FY97	FY98A	FY99A	FY00E
Revenue				
Revenues	0	21,604,165.00	481,000,000	1,467,000,000
Cost of Revenues:				
Products Costs	0	22,335,750	427,951,680	1,145,000,000
Supplier Warrant Costs	0	0	11,142,277	25,200,000
Total Cost of Revenues	0	22,335,750	439,093,957	1,170,200,000
Gross Profit	0	-731,585	41,906,043	296,800,000
Expenses				
Expenses:				
Supplier start-up warrant costs		0	98,389,011	52,750,000
Sales and Marketing		20,702,631	66,426,621	160,000,000
General and Administrative	513,000	18,458,259	20,851,954	44,000,000
Systems and business development	2,000,000	10,619,679	10,603,048	27,000,000
Total Expenses	2,513,000	49,780,569	196,270,634	283,750,000
Operating Profit	-2,513,000	-50,512,154	-154,364,591	13,050,000
Interest income, net	0	395,536	6,166,878	17,000,000
Net Profit	-2,513,000	-50,116,118	-148,197,713	-3,950,000
Earnings Per Share	0	-0.53	-1.05	-0.02
Weight Average Common Shares Outs	N/A	81,720,566	139816683	168,000,000
Margin Analysis (% of revenue)				
Gross Margin	0	-3%	9%	20%
Sales & Marketing	0	96%	14%	11%
General & Administrative	0	85%	4%	3%
Research & Development	0	49%	2%	2%
Operating Margin	0	-234%	-32%	1%
Net Margin	0	-232%	-31%	0%
Growth				
Total Revenue	N/A	NM	2126%	205%
Gross Profit	N/A	NM	-5828%	608%
Operating Expense	N/A	1881%	294%	209%
Operating Income	N/A	-2110%	-406%	108%
Net Income	N/A	-2094%	-196%	-97%
Fully Diluted EPS	N/A	NM	98%	-98%