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OSTK - Q2 2012 Overstock.com, Inc. Earnings Conference Call

EVENT DATE/TIME: JULY 19, 2012 / 3:30PM GMT



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Justin Ruiss *Sidoti & Company - Analyst*

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Chris Donnelly *Pacific Rock Capital - Analyst*

PRESENTATION

Operator

Good morning. My name is Jody, and I will be your conference operator today. At this time, I would like to welcome everyone to the Overstock.com Second-Quarter 2012 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions)

I would now like to turn the conference over to Jonathan Johnson, President of Overstock.com. Please go ahead, sir.

Jonathan Johnson - Overstock.com Inc - President

Thank you, Jody. Good morning, and welcome to our Second-Quarter 2012 Earnings Conference Call. Joining me today are Dr. Patrick Byrne, the Company's Chairman and CEO; and Steve Chesnut, the Company's Senior Vice President of Finance and Risk Management.

To begin, let me remind you that the following discussion, and our responses to your questions, reflect management's views as of today, July 19, 2012, and may include forward-looking statements. Actual results may differ materially. Additional information about factors that could potentially impact our financial results is included in the press release filed this morning and in the form 10-K that we filed on March 2, 2012.

During this call, we will discuss certain non-GAAP financial measures. The slides accompanying this webcast and our filings with the SEC, each posted on our Investor Relations website, contain additional disclosures regarding these non-GAAP measures, including reconciliations of these measures to the most comparable GAAP measures. Please review the Safe Harbor statement on Slide 2 of the presentation.

And with that preliminary piece out of the way, let me turn the call over to Steve to highlight some of the financial results.

Steve Chesnut - Overstock.com Inc - SVP of Finance

Thank you, Jonathan. Please turn to Slide 3, and let me start with the last bullet point. Net income for the quarter was a positive \$470,000, where that was \$0.02 per share. This is an \$8.3 million improvement over last year, and was due to a combination of revenue growth, contribution margin expansion, and lower operating expenses. On the top line, total revenue was \$239.5 million, a 2% increase from last year.

Gross margin improved 110 basis points from Q2 of last year, while contribution increased by 14% to \$29.7 million, due to a 9% increase in gross profit, and a 1% decrease in sales and marketing expense. Combined technology and G&A expenses decreased by \$3.9 million, due primarily to a reduction in compensation and legal costs.



While we don't provide it on this slide, we ended the quarter with \$60 million in cash and cash equivalents. Working capital at the end of Q2 was a negative \$7.6 million, while working capital at December 31, 2011 was a negative \$14.1 million, so a nice improvement.

Patrick, with that, let me turn the call over to you.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Thank you, Steve. Good morning, everybody. Well, that was a long time to hold our breath, but I do feel that things we have been telling you in the last quarter or two, that we were turning things around and getting the flywheel spinning back in the correct direction, have come true. Slide 4 -- I am going to be quick like bunny moving through these slides. Quarterly revenue growth, Slide 4, you see we have broken the slide, and up a little bit, not satisfactory, the market is growing 12% to 14% in general, we see. We, as I've mentioned many times, we think of our growth as we look at contribution dollar growth is what we manage everything to. However, it is still nice to get our head above water on GAAP revenue growth, and I think that if everything goes as planned, you'll see that spinning up fairly quickly.

Slide 5, gross profit growth, same basic story, only better. It's up to 9%. Slide 6, I have said in the past, 12%, 12.5% on contribution is -- seems to be the sweet spot for us. Remember, we calculate this differently than some businesses, well -- we calculate margins differently than some online businesses, but at the end of the day it all comes out in the wash when you look at the contribution dollars. And we think we are right in the sweet spot there. If we have opportunities to increase that, we actually are tending to pass them on more to our consumers than we are trying to make them stick to our ribs.

Slide 7, this is what I like seeing, contribution back up at 14% growth rate, which is the general industry growth rate. So, I am very pleased with this. This is what we manage all of our -- everything above this line really gets managed to optimize this line. I also believe you will see this accelerate nicely if everything stays on course.

Slide 8, operating expenses. I think this is a new slide in this format, isn't it, Steve?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

We had some version of this last quarter, but this is a slight --

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

It is useful to look at this at the blue and green segments together. Red is marketing, but the blue and green gives you our tech and G&A. And you can see we have, thanks to great management from my colleagues, managed that, kept that in -- gotten that tightened up a notch. But we feel very good; we are not skimping anywhere. In fact, I think we have a better innovative cycle than we've ever had before. But we -- this is good management, led especially by Mr. Chesnut, who is hawkish on our expenses.

Slide 9, quarterly net income. Back in the red -- I am sorry, back in black, \$500,000. For Q2 for us, that's not bad. Still nowhere near acceptable, but we are glad it has the right sign in front of it. Slide 10, cash flows. Steve may address those a little bit more, but again, positive -- we like that. Slide 11, GAAP inventory turns seems to be hovering just under 40. It is hard for us to break 40. And a significant thing you should know about our core returns -- I mean our core turns is -- do you want to explain that effect, Steve, of the partner returns and how that all weighs in here?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Yes. Since we take back 100% of the returns for -- including fulfillment partner, that gets weighted in to this GAAP turns, which creates a little bit of a drag on our overall turn rate.



Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Just because I know -- just a footnote on that. I don't think we actually take 100%, there are a couple partners who have something -- some other arrangement. But we take back almost 100% of our partner returns, and make our core inventory. So, that does affect and drag down a bit our core inventory turns.

Slide 12, GMROI trailing 12-month 790%; that's acceptable. Slide 13, net promoter score. This generally just stays in the 50s and 60s -- 50s, low 60s once. Slide 14, still adding new customers. We are up to 28 million people have bought from us, and about 1.5 million bought in a quarter.

Slide 15, new customers and CPA. CPA is up a little bit, but this is acceptable. And, as you know, we had a great addition to our marketing team. Tim Dilworth came in a few months ago from Coldwater Creek. Stormy is focused on building some things we haven't even been talking about publicly. So, Tim has taken this, and is doing a really fine job.

Slide 16, these are all numbers you can just calculate yourself out of our reported financials, but we are trying to save some time. The average order size is, I think, about -- it is higher than it has ever been, is it not, Steve?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

That is.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

We are seeing a mix shift in what people are coming to us for.

Slide 17, gross profit per transaction. This is nice, and this is also partially a reflection of that mix shift, as well as improvements in our supply chain. We keep on finding basis points to squeeze out of our supply chain. It is really, it is a cornucopia, just keeps on giving. We still see more places we can shave basis points out.

Slide 18, corporate employees were down about -- well, not about -- we're down 170 people at corporate from this time last year. 19% decrease, yet with a 14% increase in contribution dollars. Good management of all my colleagues -- Jonathan, Steve, Kevin, and all my colleagues here. Let's go, Jonathan or Steve?

Jonathan Johnson - *Overstock.com Inc - President*

There are a few questions that have been submitted before the call. Patrick, let me pose these to you. One set is from a shareholder, Gelu Tudose, who has three questions regarding technology, and if I can, I will just read all three.

Could Overstock leverage its investment in technology by providing that technology through license to other companies' websites? Would Overstock have a competitive advantage, given that its technology is live, tested and robust, and could it include fulfillment services? And then lastly, would there be any incremental cost to Overstock if it were to make its technology available to partners who pay a transaction fee for each transaction?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Gelu, good questions. The answers are yes, yes and no. Yes, we could leverage our investment in technology by providing this to other companies' websites, and I think we would have a competitive advantage. It is getting really good. And we've worked always with a comparatively tiny, tiny tech department compared to our big competitors and even our midsize competitors. It's small, but effective. And they have, over time, developed technology that we -- because we are a consumer -- for years we have been a consumer of other third-party technology, we have a pretty good



idea of where they are. And we now see that the stuff we have grown in-house is really good, and competitive; in some cases better than the best of the third-party technology we can find on the market. So, we could leverage that.

We would have a competitive advantage, and there would not -- there would be negligible incremental costs to doing so. This is a direction our business conceivably could go. We would form a subsidiary, and probably have to find the right -- well, we would have to find the right people to run that. We've had so many different things on our plate that it was not high on our list, but these questions are questions that we ask ourselves frequently -- should we be commercializing some of our technology? I have said the door is open to that, but we don't have any immediate plans.

Do you want to add anything, guys?

Jonathan Johnson - *Overstock.com Inc - President*

I agree with that assessment.

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Well said.

Jonathan Johnson - *Overstock.com Inc - President*

Okay, last question we've had submitted early is from Glenn Surewicz. Patrick, he asks -- what is the status of the potential stock buyback you discussed in March?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

The status is that we have not had one approved by the board. We will be having a Board meeting next week. I suspect this will be a subject to be discussed. You probably know where my heart is, Glenn, but I will, as always, defer to my colleagues. We did not get pushy about it in this last quarter because it just didn't feel it would be prudent. But now, things are at the point I think we ought to be seriously considering a modest stock buyback, subject, of course, to where the market stays or where the market moves.

Steve, do you have anything to add?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

No, I think this is a good Board discussion for next week.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Right, and I am sure that there will be fulsome opinions at the Board level on this.

Jonathan, you probably have something smart to add?

Jonathan Johnson - *Overstock.com Inc - President*

Yes, I agree, and if we choose to do it, we will certainly make the filings with the SEC, and let people know what we decided to do so. Those are all the questions we've had submitted ahead of time.



Jody, can you please prompt the listeners to see if there are any other questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Justin Ruiss, Sidoti.

Justin Ruiss - *Sidoti & Company - Analyst*

Good morning, gentlemen.

Jonathan Johnson - *Overstock.com Inc - President*

Good morning, Justin.

Justin Ruiss - *Sidoti & Company - Analyst*

Congrats on the quarter. I just have a few questions. I know expenses got cut down a lot. Does that have anything to do with legal expenses? Or is it just typically cutting down on your average wear and tear?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Some of it is head count, as we showed we are down 19% at corporate, but some of it is legal.

Jonathan Johnson - *Overstock.com Inc - President*

Some of it absolutely legal, given that our suit against Merrill Lynch and Goldman Sachs is no longer -- it is in an appeal stage and not a get-ready-for-trial stage, that is significantly less. I think legal expenses year-over-year were down \$1.6 million and then compensation was down \$2.8 million year-over-year, so that gives you a sense of some of the makeup of the better comp.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

So it's 60% is the comp, and 40% legal.

Justin Ruiss - *Sidoti & Company - Analyst*

Got you. So I'm looking at the margins the way they are now and the way they have improved. Are we looking at like a sustainable margin at this point? Maybe just for the year, going out further?



Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

In the fourth quarter, as there is a shift to books and electronics, that usually compresses it some but in general, as a general response I would say this isn't in any means unusual or a spike, this is the new norm.

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Yes, I think we have felt real comfortable where we have the pricing model right now and so I would anticipate the margins, gross margin will maintain pretty consistent with what we have seen in the second quarter. Fourth quarter there is a mix shift that will drive margins down.

Justin Ruiss - *Sidoti & Company - Analyst*

Got you.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

That happens every year.

Justin Ruiss - *Sidoti & Company - Analyst*

Okay, that is a seasonal thing. And lastly, just the one thing I am looking at is how do you feel, are you comfortable with the inventory levels that you are at now? Or is that anything that is bothering you?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Being too much, too little do you mean?

Justin Ruiss - *Sidoti & Company - Analyst*

In any direction -- where you are comfortable with the inventory?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Yes, I think --

Justin Ruiss - *Sidoti & Company - Analyst*

Are you looking to scale back? Are you looking to increase?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

I think we feel real comfortable where the inventory levels are right now and actually, I think we feel pretty good where our in-stock levels are right now. We are evaluating some of the clothing apparel footwear business, determining if we can move that from core to partner, but that is the question we are debating right now.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Steve has done wonderful job -- Steve and Dave Nielsen have done a wonderful job on working on inventory management and in-stock percentages. They've driven it up nicely.

Justin Ruiss - *Sidoti & Company - Analyst*

Perfect.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

We are doing better.

Justin Ruiss - *Sidoti & Company - Analyst*

Well thank you very much, gentlemen. Take care.

Operator

Nathaniel Schindler, Bank of America.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Hello.

Nathaniel Schindler - *BofA Merrill Lynch - Analyst*

Yes, hi, guys. Just a little question on the 19% drop in the employee base. Where were those cuts taken and do you foresee any additional cuts or attrition or the like, not necessarily real, true cuts but do you see this as an appropriate level going forward from which you will slowly grow or is this going to be -- are we going to see a continued downward trend on that line?

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

No, I don't see any further cuts and I would say here, it will be slow growth on the technology side -- among technologists, we are always looking for good technologists. Some of this is driven by the systems we have developed that are letting us automate some parts of the business that were done by hand for years. So part of it is just a reflection of the systems that they've developed and you might see a slow growth in technologists but certainly, there is not any move to eliminate any more jobs. Jonathan?

Jonathan Johnson - *Overstock.com Inc - President*

And to answer the first part of your question, over the past year as we've managed expenses, each department has contributed to that effort. I wouldn't say there is any one group that has been particularly hard hit by some of the employee downsizing, so it is across the board.



Nathaniel Schindler - *BofA Merrill Lynch - Analyst*

Just a little bit more on that. There is a pretty significant -- about \$500,000 drop just quarter-over-quarter in your technology line, yet no discernible move in the depreciation. So I am figuring that is mostly people, right?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Yes, we've had some attrition in the technology line.

Jonathan Johnson - *Overstock.com Inc - President*

We've had attrition, and as Patrick says, that is a group of employees that we are trying to hire and backfill and grow that group.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

We would take 100 tomorrow. We tend to hire only at the senior range in developers so they are pretty hard to come by, but we would take 100 tomorrow. It's really -- the gap is recruiting, getting people to relocate.

Nathaniel Schindler - *BofA Merrill Lynch - Analyst*

Makes sense. Great, thank you.

Operator

Chris Donnelly, Pacific Rock Capital.

Chris Donnelly - *Pacific Rock Capital - Analyst*

Hey, guys, thanks for taking my question, and congratulations on the incremental improvements in the business. My question that I have relates to your thoughts on cash flow generation in the second half of the year.

I know you guys don't give guidance, but maybe if you can directionally talk to us about your thoughts on free cash flow this year versus last year, and if we can get any incremental improvement in that metric as well as where do you think we shake out the year in terms of cash balances?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

As we think about the year, obviously relative to where we were last year at this time, we've seen on a year-to-date basis through Q2 net income has improved --

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

[Like minus \$8.2 million to plus \$3.2 million] (corrected by company after the call).



Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Obviously, the improvement on the net income side we think will continue going into the back half of the year. Capital spending will be slightly less than last year, so as you think about it from a free cash flow standpoint, we'll see improvements obviously in the P&L side that will be slightly less than last year's capital spending. That's probably the best way to think about it.

Chris Donnelly - *Pacific Rock Capital - Analyst*

So, let's just say last year you generated about \$16 million in free cash flow. Is it a reasonable expectation that free cash flow this year generation would be better than last year?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Yes, Chris, we don't -- I mean obviously you've got all the numbers, you can go ahead and calculate what you think free cash flow is going to be, but I think our general statement is we have seen the improvement in the P&L. We anticipate that we will continue to see strong P&L performance in the back half, and then capital spending will be slightly less than last year.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Can I add something to that?

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

Yes, you may.

Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

I think we are going to crush it, but that is just me and my natural optimism. These guys are, of course, conservative as they should be, but I feel really good about where we are and what's happening, and I think we are going to do far better.

Chris Donnelly - *Pacific Rock Capital - Analyst*

Yes, I love the improvements in the business. My only source of concern is that free cash flow through the six months of this year is worse than last year. I know there's seasonal factors, so on and so forth, but we have had improved net income yet it hasn't translated into free cash flow, so that is why I ask.

Steve Chesnut - *Overstock.com Inc - SVP of Finance*

I think last year also, if you look at -- last year where we were, we did a lot of work around inventory and trying to get the inventory brought down and in line, so there was a lot of movement in that free cash flow that was driven because of working capital, and specifically around inventory. Where this year, you see the improvements, working capital is pretty stable and the improvements are driven on the P&L side and a little bit on the capital spending side.

Chris Donnelly - *Pacific Rock Capital - Analyst*

Okay. Thank you.



Patrick Byrne - *Overstock.com Inc - Chairman and CEO*

Thank you. Any more questions?

Operator

There are no further questions at this time. I will now turn the conference over to Jonathan Johnson.

Jonathan Johnson - *Overstock.com Inc - President*

Jody, thank you. We thank our investors, the analysts that call in and others that are interested. We are going to get back to work and look forward to talking to you again at the end of Q3. Bye-Bye.

Operator

Thank you. That concludes today's Overstock.com Second Quarter 2012 Earnings Conference Call. You may now disconnect.

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