

## IACI: JUST AIN'T SO, MR. DILLER!

Date: August 6, 2003

Market Capitalization: \$20.2 billion

Price: \$36.07

In previous updates, we emphasized IACI's practice of including merchant deposits as part of free cash flow. This is what we wrote with regard to the "deferred merchant bookings" account. "USAI would never be entitled to the bulk of the cash that sits in the line item 'deferred merchant bookings.' This is why there is such a huge disconnect between USAI's earnings and USAI's cash flow numbers. For these two segments [Expedia and Hotels.com], cash flow from operations (also free cash flow for that matter) includes the increase in merchant deposits. A relative small portion of this cash will be earned in future periods. USAI will never gain title to a huge chunk of the cash, which has to be passed onto the merchants. USAI acts merely as a conduit... By applying a free cash flow multiple to USAI's reported free cash flow, one is effectively attributing value to a portion of the cash flow that really should not get such recognition. It is true that the additional cash represents a free float. In this sense it contributes value, but hardly deserves an outsized valuation multiple."

This item is material. The latest earnings release reports free cash flow of \$823 million for the first six months of the year. This includes an increase in cash balances that belongs to hotels and airlines of \$238 million, that is, 29% of the supposedly free cash flow (FCF) number. With a market capitalization of \$23 billion, an \$823 million free cash flow multiple translates into a FCF multiple of 28. If we exclude the \$238 million in increase merchants' cash, the FCF multiple goes up to 39.

We would like to think that somehow our criticism caught management's eye. How else does one explain the discussion in this quarter's earnings release of why these deposits are part of free cash flow?

Management explains: "These balances [the merchant deposits] are comparable to payables and receivable balances in other companies, except that the benefit or 'float,' that we get is inherent in our business model. It represents the real cash earnings power of our company, and is reflected in increased working capital... It is similar to any other cash inflow in the normal course of business [oh no, it's not!] and we view this as permanent cash [a perpetual loan, perhaps] that we can put to work."

It is disconcerting in a way that management says it looks at free cash flow as a measure of the "strength and performance of our businesses," not for valuation purposes – disingenuous, or what? "In our view, applying 'multiples' to free cash flow is inappropriate because it is subject to seasonality and one-time events... our primary valuation metric is Adjusted EPS."

According to unadjusted GAAP, the company lost \$0.11 per share (\$44 million) the past six months, which does not compare well against the supposedly \$823 million free cash flow number and should raise an eyebrow or two.

The fourth paragraph of the earnings release reports cash from operations of \$939 million for the first six months of the year but provides no detail about GAAP or "Adjusted GAAP" for the first six months of the year. The "primary valuation metric" for the first six months of 2003 eventually receives coverage on page 13 of 18. Some might say management is giving preference to the free cash flow numbers published earlier on

page 6 of 18. Adjusted net income, or earnings Nirvana as we referred to it in our April 2003 update, was \$259 million, or \$0.35 per share.

The fourth bullet point as part of the headline news in the press release announced “Year-to-date net cash provided by operating activities of \$939 million.”

The fourth paragraph gave prominence to free cash flow: “For the six months ended June 30, 2003, net cash provided by operating activities was \$939 million, compared with \$439 million in the prior year period. Free Cash Flow was \$823 million, compared with \$306 million in the prior year period.” The fifth paragraph mentioned the \$0.18 in adjusted EPS.

### Management’s Folly

Here is a simple example to illustrate management’s folly. Assume Laura Lane (fictitious person) acts as a collection agent for a rental property. She collects \$1,000 per month and retains \$100 as commission. She has to remit the \$900 to the property owner by the end of the month following the month of collection. She has automated the process of collection and remittance with the result that she has no business expense. Also, ignore taxes. How should Laura account for all this? Laura has a shrewd idea but nonetheless consults her friend Mr. Tiller (fictitious person) on the matter.

This is how Laura intends accounting for the transactions.

#### Journal Entries

<b>Month 1</b>		
<b>(\$)</b>	<b>Debit</b>	<b>Credit</b>
Debit: Cash	1,000	
Credit: Commissions Earned		(100)
Credit: Payables – Property Owner		(900)
<b>Month 2</b>		
<b>(\$)</b>	<b>Debit</b>	<b>Credit</b>
Debit: Payables – Property Owner	900	
Credit: Cash		(900)

#### Income Statement – Fair Presentation

<b>Month 1 - Income Statement</b>	
<b>(\$)</b>	
Fee Income – commissions	100
Expenses	<u>0</u>
Net Income	100

#### Cash Flow Numbers – Fair Presentation

<b>Month 1 - Cash Flow Statement</b>	
<b>(\$)</b>	
Net Income	100
Adjust for Changes in Working Capital*	900
Cash from Operations	1,000
Beginning Cash	<u>0</u>
Ending Cash	<u>1,000</u>

**Free Cash Flow Calculation**

Cash from Operations	1,000
Adjust for pass-through payable	<u>(900)</u>
Free Cash Flow	100

*\* Increase in Payables – Property Owner*

Free cash flow generated by rent collection activity of \$100 ties up nicely with net income.

On showing her financial statements to Mr. Tiller, he smiles and tells her that perhaps she doesn't get it. He proceeds by presenting her with the following:

**Income Statement – Treating Pass-through Payment as Revenue****Month 1 - Income Statement**

<b>(\$)</b>	
Revenue (commissions and rent)	1,000
Expenses (rent pass-through)	<u>(900)</u>
Net Income	100

**Cash Flow Numbers – Treating Pass-through Payment as Revenue****Month 1 - Cash Flow Statement**

<b>(\$)</b>	
Net Income	100
Adjust for Changes in Working Capital*	<u>900</u>
Cash from Operations	1,000
Beginning Cash	<u>0</u>
Ending Cash	1,000

**Free Cash Flow Calculation**

Cash from Operations	1,000
No adjustment for pass-through payable	<u>-</u>
Free Cash Flow	1,000

*\* Increase in Payables – Property Owner*

Presto! Free cash flow generated by rent collection activities equals \$1,000.

She marvels at Mr. Tiller's genius and promptly proceeds to the bank where she applies for a business loan. The bank manager questions Laura about the cash generation power of her business. Laura informs the bank manager that her business generated \$1,000 in free cash flow the previous month. The bank manager does some mental arithmetic: \$1,000 per month times 12 equals \$12,000 per year. Apply a free cash flow multiple of 10 and he quickly values the business at \$120,000. He tells her that he will advance her a loan equal to one quarter of the value of her business, subject to a few formalities. Laura's too-good-to-be-true free cash flow number nonetheless puzzles him.

Laura leaves the bank seeing nothing but dollar signs and luxury cruises. "Imagine that, my fully automated rent collecting agency is worth \$120,000 and I'm getting a \$30,000 loan straight out of the gate," she gratefully informs Mr. Tiller.

Mr. Tiller immediately recognizes her dilemma. If she fails to win new business, free cash flow will drop immediately to \$100 per month, from month 2 onwards. The bank manager is in for a rude awakening.

### When the Music Stops

The presentation below illustrates what happens in succeeding months, assuming Laura services only one contract and prepares a financial statement based on Mr. Tiller's recommendation.

#### Only One Contract

(\$)	Month 1	Month 2	Month 3
Contracts	1,000	1,000	1,000
- commission	100	100	100
- rent	900	900	900

#### Treating Pass-through Payment as Revenue

Income Statement			
(\$)	Month 1	Month 2	Month 3
Revenue (commission and rent)	1,000	1,000	1,000
Expenses (rent – pass-through)	(900)	(900)	(900)
Net Income	100	100	100

The above presentation inflates revenue, but in the case of IACI, management has found a way to explain the oddity to the SEC's satisfaction. Notice the impact on net income is zero.

#### Cash Flow Numbers - Treating Pass-through Payment as Revenue

Cash Flow Statement			
	Month 1	Month 2	Month 3
Net Income	100	100	100
Adjust for Changes in Working Capital	900	0	0
Cash from operations	1,000	100	100
Beginning Cash	0	1,000	1,100
Ending Cash	1,000	1,100	1,200
<b>Free Cash Flow Calculation</b>			
Cash from Operations	1,000	100	100
No adjustment for pass-through payable	-	-	-
Free Cash Flow	1,000	100	100

Anybody with good eyesight will see that the cash flow numbers above bear no relation to the net income line in year 1 – something must wrong. You betcha!

#### Payables

(\$)	Month 1	Month 2	Month 3
Beginning of the month	0	900	900
Accrual – Property Owner	900	900	900
Payment – Property Owner	0	(900)	(900)
End of the month	900	900	900
- change	900	0	0

To satisfy the bank manager and keep free cash flow at \$1,000 in month 2, Laura would have to add at least another \$900 monthly collection contract on which she collects a \$100 commission. Free cash flow will be \$200 in commissions plus an \$800 increase in payables, to equal the \$1,000 of month 1. Rather, assume she adds one \$1,000 contract a month for the first three months and nothing in the 4<sup>th</sup> month.

#### Adding one contract per month for the first three months only

(\$)	Month 1	Month 2	Month 3	Month 4	First Contract	Second Contract	Third Contract
Contracts	1,000	1,900	2,700	2,700	1,000	1,000	1,000
- commission	100	200	300	300	100	100	100
- rent	900	1,700	2,400	2,400	900	900	900

#### Treating Pass-through Payment as Revenue

##### Income Statement

	Month 1	Month 2	Month 3	Month 4
Revenue (commissions and rent)	1,000	2,000	3,000	3,000
Expenses (rent – pass-through)	(900)	(1,800)	(2,700)	(2,700)
Net Income	100	200	300	300

Again, the above presentation inflates revenue, but then that is the object of the exercise, even though it has no impact on net income.

#### Cash Flow Numbers - Treating Pass-through Payment as Revenue

##### Cash Flow Statement

	Month 1	Month 2	Month 3	Month 4
Net Income	100	200	300	300
Adjust for Changes in Working Capital	900	900	900	0
Cash from operations	1,000	1,100	1,200	100
Beginning Cash	0	1,000	2,100	3,300
Ending Cash	1,000	2,100	3,300	3,400

##### Free Cash Flow Calculation

Cash from Operations	1,000	1,100	1,200	300
No adjustment for pass-through payable	-	-	-	-
Free Cash Flow	1,000	1,100	1,200	300

In this dubious scenario, there is no direct correlation between the cash flow numbers and net income. Free cash flow and net income are proxies of each other. All transactions of a cash nature that appear first in the income statement by virtue of the accrual system must eventually be accounted for in the free cash flow numbers, albeit in a different year(s). All transactions of a balance sheet nature that feature first in the cash flow statement will only form part of the free cash flow calculation if they also impact the income statement in current or future years as either items of income or expense. For example, capital expenditures eventually turn up in the income statement as depreciation. Pass-through deposits, no matter how nice a float they provide, never find their way into the income statement, except if management treats them as revenue, only to be removed immediately as an expense, with no impact on net income.

#### Payables

	Month 1	Month 2	Month 3	Month 4
Beginning of the month	0	900	1,800	2,700
Accrual	900	1,800	2,700	2,700
Payment	0	(900)	(1,800)	(2,700)
End of the month	900	1,800	2,700	2,700
- change	900	900	900	0

The only “honest-to-goodness” way of dealing with a pass-through is to exclude it when calculating free cash flow, as the presentation below shows. It uses the same facts as the previous example.

#### Adding one contract per month for the first three months

	Month 1	Month 2	Month 3	Month 4	First Contract	Second Contract	Third Contract
Contracts	1,000	1,900	2,700	2,700	1,000	1,000	1,000
- commission	100	200	300	300	100	100	100
- rent	900	1,700	2,400	2,400	900	900	900

Only revenue to which the company has a legitimate right of ownership counts as revenue for income statement purposes. The same goes for cash and the free cash flow numbers.

#### Income Statement – Fair Presentation

Income Statement		Month 1	Month 2	Month 3	Month 4
Revenue (commissions)		100	200	300	300
Expenses		0	0	0	0
Net Income		100	200	300	300

#### Cash Flow Numbers – Fair Presentation

Cash Flow Statement		Month 1	Month 2	Month 3	Month 4
Net Income		100	200	300	300
Adjust for increase in Working Capital		900	900	900	0
Cash from operations		1,000	1,100	1,200	300
Beginning Cash		0	1,000	2,100	3,300
Ending Cash		1,000	2,100	3,300	3,600

#### Free Cash Flow Calculation

Cash from Operations		1,000	1,100	1,200	300
Adjust for pass-through payable		(900)	(900)	(900)	0
Free Cash Flow		100	200	300	300

Eliminating the pass-through payments brings the net income line in sync with the free cash flow line. One can show these numbers to any bank manager, without worrying about misrepresenting the true cash flow generating power of the business.

Imagine if Laura lands a new contract that collects \$10,000 on rent in the last month of the year, but she is only entitled to \$300 commission. The correct way to assess the

transaction is that free cash flow will go up by \$300 per month. Using Mr. Tiller's method, free cash flow will get a \$10,000 boost in December.

### **Enron's History Lesson**

If this sounds too far-fetched, think again. Here is a slice of history straight out of Enron's books.

At the end of 2000, Enron's reported cash flow from operations was \$4,779 million, five times the reported net income number. No doubt, investors like our fictitious Mr. Tiller accepted the number at face value and offered to pay \$70 per share for Enron stock.

Enron's cash flow statement in the 3<sup>rd</sup> quarter of 2000 reported a paltry \$100 million in cash from operations. Yet, at year-end, this number had ballooned to \$4,779 million. Enron's management offered this vague explanation for the huge increase in cash from operation:

*"Net cash provided by operating activities increased \$3,551 million in 2000, primarily reflecting decreases in working capital, positive operating results and a receipt of cash associated with the assumption of a contractual obligation."*

**First observation:** Substitute the words "contractual obligation" for "deferred merchant bookings."

At the time, our comments were, "There is a mystery tied up in the wording '... and a receipt of cash associated with the assumption of a contractual obligation.'" This mystery was only resolved in the 2<sup>nd</sup> quarter of 2001 when the picture no longer looked so rosy, and management was forced to come clean.

To explain the \$464 million deficit at the operating cash line in the 1<sup>st</sup> quarter of 2001, management offered one brief sentence:

*"Cash used in operating activities in the first quarter of 2001 reflects cash provided by first quarter operations offset by increased working capital requirements."*

**Second observation:** When these "contractual obligations" reverse, it happens fast and the numbers can be huge, relatively speaking. In the most recent press release, IACI's management asserts that "if these businesses were to decline or if the model otherwise changed, it would negatively impact working capital and we would communicate this to investors." By the time the cat wiggles out of the bag, it will be too late. The best insurance is not to count on these cash flows, and management should know that.

Enron's management was tempting fate when it added these words to the 1<sup>st</sup> quarter's 10Q, because it blew up in its face:

*"Enron expects increased cash flows from operating activities in subsequent quarters of 2001 related to its price risk management activities."*

The 2<sup>nd</sup> quarter of 2001 arrived with a surprise package. Cash from operations now showed a deficit of \$1,337 million. What happened to the increased cash flows management boasted about in the 1<sup>st</sup> quarter? Management explains – this time wordier and startling to say the least.

*“Cash used in operating activities in the first half of 2001 reflects cash provided by operations and price risk management activities, offset by net cash used related to margin deposit activity. Excluding net margin deposit activity, cash provided by operating activity was \$1,005 million. Enron received significant cash deposits as credit collateral during the fourth quarter of 2000 resulting from volatility in the power and gas markets. During the first six months of 2001, net deposits of \$2,342 million were returned as volatility in the commodity prices have (sic) declined.... Management anticipates cash from operating activities in the second half of 2001 to be positively impacted by reduced working capital requirements and overall operating activities.”*

For the first time, management acknowledged that the cash flow number at the end of 2001 was not that a great indicator of cash from operations. The vague reference to “significant cash deposits” is inadequate. In our analysis below, we assume that these deposits amounted to at least \$3 billion in the 4<sup>th</sup> quarter of 2000. They could well have been more. “Assets from price risk management activities” increased by \$6.3 billion in the 4<sup>th</sup> quarter of 2000 vis-à-vis the 3<sup>rd</sup> quarter.

In the 2<sup>nd</sup> quarter of 2001, when the cash deposits declined, management wanted investors to exclude the negative effects of this so-called “net margin activity.”

The analysis below excludes cash flows related to cash deposits associated with “Merchant Assets.”

#### Adjusting Enron’s cash flow for “Merchant Assets” – cash deposits

	1996	1997	1998	1999	2000	Q1 '01	Q2 '01
Cash Flow from Operations	884	211	1,640	1,228	4,779	(464)	(873)
Adjust for Cash Deposits*	177	(96)	(435)	(239)	(2,676)	183	1,320
Cash from operations - fair presentation	1,061	115	1,205	989	2,103	(281)	447
Fair presentation as % of inflated number	120%	55%	73%	81%	44%	61%	
Cumulative overstatement since 1996					(3,269)		

\* 10K language “Merchant Assets”

**Third observation:** Once these deposits become part of the cash flow numbers, they begin to grow. In Enron’s case, they got out of control by the end of 2000. Management should have stopped the rot in 1997, by instructing investors to adjust the reported cash from operation numbers for increases in cash deposits.

Once the hotel industry figures out that IACI is using half a billion dollars of its cash as a float, it may change the rules and ask for a speedier remittance of customer deposits. Under the “fair presentation” method of calculating free cash flow, a change in rules would make no difference and rightly so. Under the current way in which AICI calculates free cash flow, the impact could be huge, similar to Enron’s experience. We cannot fault management for trying to alert investors of this fact in the small print. Of course, what matters most is how the headline news touts the cash flow numbers.

**Conclusion:** We are still working on an update of IACI’s 2nd quarter earnings release, but felt that management’s assertions with regard to the merchant deposits needed immediate attention. When assessing the company’s free cash flow, put yourself in the position of Laura’s bank manager. Which number more faithfully represents the cash

flow generating ability of Laura's business at the time of her visit to the bank – the \$1,000 or the \$100?

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