MANAGEMENT DISCUSSION SECTION

Operator: Good day ladies and gentlemen, thank you for your patience and welcome to the First Quarter 2006 Overstock.com Incorporated Earnings Conference Call. My name is Bill and I will be your conference coordinator for today. [Operator Instructions] I would now like to turn the conference over to your host for today's presentation, Mr. David Chidester, Senior Vice President of Finance. Please proceed.

David Chidester, Senior Vice President of Finance

Thank you, good morning and welcome to Overstock.com's first quarter 2006 conference call. Participating with me on the call today is Dr. Patrick Byrne, Chairman and CEO of Overstock.com. Please keep in mind that the following discussion and the responses to your questions reflect management's views as of today April 28th, 2006 only. As you listen to the call I encourage you to have our press release in front of you since our financial results, detailed commentary, and the letter to shareholders are included and will correspond to much of the discussion that follows. As we share information today to help you better understand our business it is important to keep in mind that we will make statements in the course of this conference call that state our intentions, hopes, beliefs, expectations, or predictions of the future. These constitute forward-looking statements for the purpose of the Safe Harbor provisions under the Private Securities Litigation Reform within the meaning of section 21a of the Securities Act of 1933 and section 21e of the Securities and Exchange Act of 1934. These forward-looking statements involve certain risks and uncertainties that could cause overstock.com's actual results to differ materially from those projected and these forward-looking statements. Overstock.com disclaims any intention or obligation to revise any forward-looking statements. Additional information concerning important factors that could cause actual results to differ from those in the forward-looking statements is contained from time to time in documents that the company files with the SEC, including but not limited to its most recent reports on forms 10-K, 10-Q, 8-K and F-1. I will now turn the call over to Patrick.

Patrick M. Byrne, President

Thank you, David. I'm going to take – we. There are 40 people on the call, but they said there were several hundred trying to log in. Rather than delay, we'll try to start and I'll just spend the first few minutes talking about this crusade, which as I know, people always ask me about privately and not publicly. And that will give time for the operators to log in to what I understand is a very big queue. So, I'll just vamp till ready, telling you my thoughts on this.

One is that I know that some will say this crusade is a betrayal of my responsibility as CEO. I could say that I'm certain that it isn't, and I'd be almost completely truthful. I could say that the crusade doesn't interfere with my duties to this CEO and that would be largely truthful, but the simple truth is this is: I think we, in the financial community, are living over a deep fissure. I'm not happy about. I lose sleep about it, and everyone knows I'm in quite a donnybrook about it. This is a moment where I can talk to you without being filtered through a few dishonest journalists.

The simple problem is there is a number of ways in which stock trades can fail to settle, or there can be an expansion in the number of shares, or share-like things. There are failed short sales, which are the famous naked short which I don't even think is the bulk of the problem. I don't think it's – I think it's a lot less than half of the problem. There are failed long sales, open positions at the DTCC, desked trades at the brokers, and share entitlements, which are very slippery. I call all of these, “phantom shares,” not to be outrageous, but…. I'm saying on the one hand there's the number of shares that the company issued and which have been borrowed once and then sold again. So they have a clear chain of title. Then there are the total number of shares that the world thinks they own. And there's a difference between the two, in some companies. And whatever that difference is – you can call it "phantom shares."

I understand that they present 3 problems. It has blown our system of corporate governance. The current issue of Bloomberg magazine has a fantastic article about this, with a whole bunch of people from the back office of Wall Street, the securities transfer people. And they're talking about how votes are cast twice and one guy says, "Votes are cast twice on almost every matter of substance. It definitely can and does affect the outcome of corporate elections." Well, you can't hold corporate elections if people in the back office are just throwing out extra proxies to make votes tally. I thought of doing some kind of – look, I'm sure many people on the phone, had - or who will join this call - had problems getting their proxies. We don't know what that – you know, we mailed them out within the window. Everyone should have got them. I heard some complaints. I'd like to know how many people – of course, we can't find out how many people really got proxies. I thought actually about putting up some sort of non-binding public referendum to my shareholders on the subject of, "Should I be fighting this crusade or not?" I think it's that - I would probably get 65% of my shareholders saying they're against it, and I'd get the other 210% would be for it.

The second thing it does is the market – these phantom shares distort a market price. The orthodox response is that can't happen. If unsettled trades are dumped into the system, the market can't move very far before some ocean of money comes in to support it. The orthodox answer is right if you're talking about IBM. But if you're talking about a fledgling firm paddling into the market, and somebody dumps a bunch of phantom shares into its market, of course it can be capsized. Everyone on the phone has taken economics. Stock in an illiquid market will act like a commodity. Phantom shares will shift the supply curve to the right. That will collapse the equilibrium price, which - as the guy selling fake Rolex's on the street in front of you can explain.
It doesn't happen with IBM, but it can happen with startup companies, software firms, drug companies, especially if their business is one about which it's easy to confuse the public, which is easy to do if you have a stable of captive reporters to whom you can dictate what you want written.

Speaking of which, I want to correct something. Over and over, you see reporters saying, "Byrne blames his stock price on naked shorting." That's a lie. And you'll notice that none of the guys who attribute that to me – guys and gals – ever have a quote supporting it. I've never even lamented Overstock's price. I've never come out and said "we're undervalued." That's a lie. I've never discussed Overstock's valuation within the context of naked shorting or said that naked shorting has driven our stock down. The journalists that write those articles and repeat it – parrot-like, you know, they repeat it – never have a quote to support it. And Holman Jenkins in a recent Wall Street Journal article actually went so far as to fabricate a quote. I mean he repeated all the standard party line, and he actually fabricated a quote that said, "If I'm crazy, why am I running a public company?" or something like that. That quote was completely fabricated. It doesn't resemble, it's not a paraphrase of anything I've ever said. And he very artfully constructed the sentence so that when I went back at him, I'm sure he will say, "oh that was a hypothetical quote. It wasn't a fabrication; it was a hypothetical quote." So he was lying when he said that. I mean, this has really gotten strange. We've got columnists in The Wall Street Journal fabricating quotes out of thin air.

Third, the real problem is I think that unsettled trades may be collectively compromising the system. Why do I think that? Well for one thing the SEC says so on its own website when they explain why they grandfathered in January '05 all failed deliveries. They say, "The grandfathering provisions of Regulation SHO were adopted because the commission was concerned about creating volatility where there were large pre-existing open positions." Now those would be the same "large, pre-existing open positions" that people say I'm nuts to believe in. So the SEC acknowledges that it can't clean up the problem for fear of the volatility that it would force these unsettled trades to close. I think that's *my* point. Beyond the SEC, there's been a bunch of economists like Robert Shapiro, Leslie Boni who study these interesting papers. The deep problem is that DTCC is a – we've a clearing system the DTCC, it's a opaque corporation owned by the banks that use it in proportion to their use, i.e., therefore Goldman and a few others. The SEC by all accounts sends over junior regulators who say, "How does the DTCC do its job? Okay, are they doing it?" Not even clear if the SEC gets that much cooperation. It's SRO except on the days when it isn't. When a DTCC gets subpoenaed by state regulators, it just rips them up. And it clears 30 times the world's grossed world product. So, it's owned by the people who profit if it turns a blind eye to issues like, do they deliver things when they sell them? So, in a nutshell, I'd say, does that sound kosher? Does that sound like the right way that way to organize affairs?

So, I didn't want to fight this fight. I know it sounds corny, but it was my *dharma* to fight this fight. I'm telling you there is a crack in the financial system. It's filling up with phantom shares until they so warp the market, the SEC is saying it has to grandfather the unsettled trades for fear of creating volatility with their large pre-existing open position. So, what do you think they are talking about? What does it mean when the regulators said there's a large amount of unsettled trades in the system, and If we force them to settle, it would create volatility extreme enough, that we, the SEC are afraid to make people do it. Does that say anything to anybody here?

So, I'm sure Roddy Boyd with the New York Post and others have a few of the – what I've said already – "oh my god, you said 'kosher,' you said 'dharma,' what a nut!" and "it signifies something... Im sure it signifies something." With that said, life for them is to doing "Cats!" over and over again. And of course the New York Post is for people who move their lips when they read People. .

But in closing, these guys can laugh all they want. I think that – first, I don't think I seem much like a guy who cares a whole lot about what other people think of me. The financial community can continue its *après moi le deluge* mentality. But I think that you ought to ask yourselves, what's the world going to look like if I turn out to be right. Now, the punch line is: I am right and I think that folks are going to find that out any moment now, that I'm right about a lot of this.

So, I've given 10 minutes, which should have given time for the operators to process the long queue that I was told existed. We'll go to the company.

I told you we ran into a ditch. It's going to take us the first two quarters, at least, to get out of the ditch, and I think the third to get back with momentum. We grew 9% and lost $16 million. In the second quarter, we're going to lose about $16 million. When I say that, by the way, I mean, if it were $20 million, if I thought we were going to lose $20 million, I'd say "we're going to lose somewhat more than $16 million." I think I'm going to lose $14 million to $18 million in the second quarter, and I think we're going to grow — growth may pick up a little bit. In the third quarter, we're going to start growing somewhat faster again, and losses will come down. I think in the fourth quarter we start making good money and then we'll back and we have our momentum back up.

David Chidester, Senior Vice President of Finance

Okay. I'll walk through some of the financial results of the first quarter and note that all comparisons that I make will be against our results from the first quarter of 2005 unless otherwise stated. Total revenue was $180 million, an increase of 9%. Gross margins were 14%, down 90 basis points. Gross profit dollars were basically flat at around $25 million. Sales and marketing costs were down to 7.3% of sales. That's a 280 basis points improvement from last year and this is a reflection of a 22% decrease in overall marketing expense year-over-year. However technology and G&A expenses combined were 15% of sales in the quarter compared with 7% last year. And with the significant investment we made in technology and G&A during 2005 to support future growth, we began 2006 with a much larger expense structure. This combined with slowing growth will result in a significant increase to technology and G&A as a percent of sales for the fist 9 months of 2006.

A big portion of the increased expense structure is depreciation. Total depreciation was approximately $7 million this quarter and should be around $30 million for the year. In addition, almost $1 million of the tech and G&A expense in the quarter is for stock-based compensation as we'll now record stock-option expense in accordance with FAS 123(R). Although we have never been proponents of EBITDA, I will point out that between depreciation and options expense, approximately $35 million of our expense structure in 2006 will be non-cash. Total operating expenses grew 42% to $40 million, which translated into a $15 million operating loss or 8.3% of sales. Our net loss was $15.9 million, 8.8% of revenue and 82 cents per share compared to a 22% loss per share last year.

We ended the quarter with cash and marketable securities of $52 million and an additional $30 million of availability on our lines of credit for a total of $82 million of cash plus availability. Cash at the end of the quarter included $49 million of foreign currency bonds that were meant to mature this fall, however subsequent to the end of the quarter, we sold the foreign bonds, turned them back into cash. In addition, we plan further reductions in inventory over the next 3 to 4 months, which will also enhance our liquidity. Lastly, operating cash flows during the quarter were an outflow of $73 million and free cash flows were an outflow of $80 million. For the trailing 12 months, cash flows from operations were an outflow of $44 million and free cash flow was an outflow of $82 million. You'll find additional quarterly metrics on our Investor Relations website. With that, I will turn the call back to Patrick.

Patrick M. Byrne, President

Thank you, David. We're trying something new, both a new vendor for the webcast and I'm doing this offsite so I see the slides at the same time the – you, the viewer, see them. In the past, if you've wondered why we've had all this complaints that I was talking about slides that wasn't synchronized with what you were seeing. It was because from inside the system, you saw it at one speed and the world saw it a lag. So I'm at home so I should see these at the same pace you do. Operator, could you go to the next slide please?

Kevin Moon, David Chidester, can you advance it? Patrick, go ahead and you advance it yourself.

Patrick M. Byrne, President

I can advance it. Sorry. The controls did not come up for me to advance it. Well, while they are getting that advanced, I will just work on – I will explain what the first slide is going to show you. It is going to show you a chart of our order management score, and this is one of the things that actually got Jason out of his semi retirement to – well, if you have trouble, I do believe people at home can download this, can download this and watch it later perhaps, or follow along. We have a way of scoring basically what we think of as aggravation points to the customers, and it is a very big matrix that says, if this order has been late for, and for this kind of reason, for this many days, how many points it is per day and everything, so it is easy to rack up a lot of points, when you are doing 20-30,000 orders a day or 50, 60, 70,000 as we were in the fourth quarter, and of course, our ERP system came in August, September, is when everything started to unspool, so when we started calculating the score, we were well over, about a million and a half points. We have it down to 15,000 points now. What that means is that it has been 99% cleaned up, and 15,000 points may even sound like a lot, but it can be a – a small number of orders can generate hundreds of points, so we really do have things about 99.8% tightened. In fact, I think they are tighter than they ever were before.

David, can you not advance the slide from your end?

David Chidester, Senior Vice President of Finance

I think everybody advances the slides with the little arrows at the bottom on their own. Do you not have that at the bottom of your...

Dr. Patrick M. Byrne, President

I never. I do not.

David Chidester, Senior Vice President of Finance

So, people can advance it as we go.

Dr. Patrick M. Byrne, President

Okay, I have some jibberish HTML has come up, rather than my any buttons for me. Okay, so you advance it as you go. I was just talking about Slide 4, as the ERP implementation, order flow management score.

Next, on Slide 5, marketing efficiency. We have spent 22% less on marketing and had 9% growth. Nothing stellar [ph], but it is interesting. We just had a vendor who does a lot of good statistical analysis do a huge multi regression going back several years on all of this different spending, and how it has affected growth, and what she came up with was – and we have been operating on some really two sets of very basic rules that can be explained, each one of them can be explained in five minutes, and I probably have explained them at times, and just with these very simple rules, it determines how much we spend, how we whack it between online and offline, and then online, how we chop it up within online spend. We did not have a good rule for how we handle offline, but still, she came back with this multivariate regression that said – it turned out we had gotten it. Her numbers came out surprisingly close to ours.

Page 6. Net promoter score. We have started paying, I am not a big business fad guy, but there is a book that has really impressed me by Fred Reichheld. The same guy who did the Loyalty Effect ten years ago, which has had quite a – if you read about CRM and the value of loyalty and the lifetime value of customers and stuff, a lot of that came out of the book, The Loyalty Effect or at least he ties it together. He's coming out with a new book called The Ultimate Question. It seems quite plausible, and it's that you count your net promoters and that is the people – a promoter, you ask people "Would you recommend me to a friend" or a company to a friend, rank them 1 to 10 and you take the people who are 9's and 10's and subtract those 1's through 6's and you get your net promoters.

And it explains a lot of the variation in results. Again, on page 6 we took off the ordinate. I can say that according to his book, the average American corporation is under 10%, I think he says 8% or something somewhere and the superstars are in the high 30's to 80's. We have surprisingly to me, even in our dip, it turns out we were in that band. We've taken out – we don't want to give the percentage number, but we – this seems like a very – you do see the dip, starting last August and what happened, and we just – I mean that breaks my heart because we spent so much time on the service, millions of people in the years past, but this last year we had that problem. Customers respect to us, and its bounced back to be almost as high as it ever was and now that we are measuring and managing to this number I do expect it to get significantly better.

I expect it to keep on improving. I think there is actually a 1 to 2-month lag effect it seems. So this – if I am really to compare it with the numbers in his book this is in the upper half of the – of the sort of total superstar score. So we seem to have a lot of happy [inaudible].

Page 7, we've gotten really focused on the customer satisfaction, we've restructured this CS organization. We're focusing on agent training, quality. We have contracted, it's been announced, with Right Now – we've decided to go with, until now we've been operating customer service on a package that literally Sam Peterson wrote, back in the summer of 2000 in the space of a couple of weeks. That's been our customer service app. This is our last sort of, sometimes I think of the last year as a big prop-to-jet conversion and I – like the airplanes in the 60's that went through prop-to-jet conversions we've gone through a prop-to-jet conversion. And Sam's home grown system while fine was inadequate for the size and the kind of features we need here.

So when that gets live which should be in June I – there's – right now customer service is costing over 2.5% of sales, I think it's possible to get that to 1%. I've heard that in other companies, I've heard that Amazon has gotten less than that. But I think it's possible to – it's actually around 2.8% , 2.8% in the first quarter and that was the right thing to do. It was a little bit higher than in the past but we had to smother our customers with love but I think it should be possible to get it down at least into the low ones.

That's why I think that there's – for example there would be 150 basis points or more to pick up.

Page 8, operations, upgrade warehouse management system. That's nearly complete and we are building and measuring the center of our warehouse, high density, takes places 3 stories and 25,000 square foot. Measuring at 25,000 square foot. I think we're going to be able to condense the 8 or 9% of our picking tube. Right now, it's been costing us last year's cost about 3 and a half bucks and total variable costs for package. I, I think it might be possible call, it should be possible I think to get to $2.50. So that's an average packages about $60. So that's about 1.6, 1.7% margin increase if that's on core only, so that translates to say 8 – point 8% increase in overall margin. So if you want to work on these numbers in the past, when we – as we've grown from 9% margin to 14, 15 and we're – I keep saying, well I think there's another 2 or 300 basis points in this, these areas. The team is doing a fantastic job managing the logistics change now. It's built a very strong team. Our returns processing has also, had been a big part of this year.

Going forward, page 9, analytics. Propeller has been integrated site wide. It's only making recommendations in some parts of the site. There's new version expected in Q2, we would have to build something that, that's highly figured a lot of different, let's say, propellers and junior propeller. But you see it, you're seeing in chart 1 on our site, site design, we've adopted a system. It's so powerful that I don't even want to tell, it's made and it's comforting. And I know they are overwhelmed with demand at this point but I know it's comforting – a company that helps you in your site design and we've got a 3% lift last month and I think there's quite a few in – just by changing one thing and we're basically doing one big test per month and optimizing things as we go. And I'd like to think it's for several months at least, sort of 3% lifts or more in each one of these changes.

And then CRM, CRM as applied it to email. We have started to personalize emails. It's giving us a somewhat between satisfactory and remarkable lift. It's not remarkable, but it's very solid and very measurable. Unfortunately, even with all our new equipment, we can only do 100,000 at first. It's just, it's so much, it uses so much power to bake the email. We're up to about 500,000 and with some changes, we may grow, we may be able to do 2 million personalized emails per day starting in probably September, October. And that's a good chuck of the 8 and a half million emails that we do have.

Page 10, comments, page 10 and last. Marketing efficiency, talked about gross margin, gross profit. Well, marketing efficiency going back. Again, we did cut way back in marketing. We have found something independent and I'll just – we do seem to have the right basic kinds of things, but this analysis of estimates we can tweak our, tweak things a little bit as well. Our gross margin is, I think it's going to stable this quarter if we keep making these changes, but I'll just give you the readers what I think there is 200, or maybe even 300 basis points. I ultimately think this is a 17 or 18% gross margin business, and I think we can get there, I think we can get there in the near future. I would like to see in the fourth quarter, certainly a number around 17. You will see us grow more slowly again in the second quarter, 10% growth is fine, as we fix all of this stuff.

Liquidity. I know folks are talking about liquidity. I do not see – I was always more comfortable doing barrel rolls closer to the ground than my passengers. I do not see us as having a liquidity crisis. Although, two years ago, as I have told people, there was a day where we rammed things down to $3 million in cash as we built inventory, and everybody – we have a good precise control on it, but in any case, we are not doing that now. We have a – just yesterday, the Lehman bond, this foreign currency bond that Lehman did a great job for us with, that was a basket of Asian currencies, we traded out of yesterday for $49.5 million, and we could have waited until September and November, and have gotten 50 million, but with the time value money, 49.5 is just as good now, and that is actually going to imply a bit of a pick up. If we had marked – it was a strange bond that the accounting is it, even knew we were getting at least 50 at the end of the period, you mark it down as you went, and as the dollar appreciated, which was a surprise. We have been marking the value of this down a couple, a few million dollars. I think about 2.5, so there will be a bit of a pick up there.

And, so we have the 50 million, we have to pay off some debt with it, but I think we are fine for this year as far as cash goes. Okay, that is, David, that is the end of mine. I am sorry I could not advance my slides. I just got a bunch of HTML come up on my screen where the buttons should have been. So, let us go to questions.

QUESTION AND ANSWER SECTION

Operator: Thank you very much sir. [Operator Instructions] And, our first question comes from the line of Aaron Kessler with Piper Jaffray. Please proceed.

<Q – Aaron Kessler>: Great, thanks Patrick and David. A couple of quick questions. One of the customer acquisition costs, given us the marketing costs decrease pretty significantly to about 7% of revenues. Why did we not see customer acquisition costs come down a little more? It looks like it is pretty flat year-over-year. And, what is your view now, given that you looked at some of the brand marketing from last year, do we still see a lift in Q1, as revenues only improved 9%? Thank you.

<A – Patrick Byrne>: David, you want to talk about customer acquisition costs? I do not have that in front of me.

<A – David Chidester>: Yes, I think it was, like Aaron said, it was flat over Q1 of last year, below $20, which is – it was not below $20 all of last year, besides the first quarter. I think the reflection of partially, as we get bigger, it is – the new customer growth is slowing, so you have got less new customers over the spend that we have, so the mix is moving a little bit more towards repeat business, than just new customer business, and that makes sense now that growth is slowing.

<A – Patrick Byrne>: We think that the value of a customer is significantly above $20 for us so we are fine with that. And I am sorry, what was the second part?

<Q – Aaron Kessler>: The second question is in terms of the brand marketing, what is your sense now from the lift you got from brand marketing over the last couple of years here? And how much of that translated into maybe the growth in the first quarter?

<A>: Well, we know we got our – we have cut way back on the brand marketing, that is where a lot of the cuts have been and it is trickling along at a much reduced rate than last year, as you may have noticed, but just measured in terms of name recognition and all that stuff, I think we built a very good brand. We went – I think we reported we went to 29% unprompted name recognition over a couple – over two years so I am favor of it but I think we have reached the point where the marketing guys say you go through these different phases of awareness, acceptance, all this stuff. We clearly have created awareness. We don't need to keep drilling people in the forehead with the same ad over and over as much as they like Sabine.   I think we can go at the other end of the extreme is something like Oreo, who just every year takes two weeks and drills the public for two weeks, everybody remembers Oreo cookies and that is all they need.

We are not there yet but you will see us stay back plus the brand advertising is – we have accomplished what we set out to accomplish and I think that we can keep it there without significantly reduced spend.

<Q – Aaron Kessler>: Great. Thank you.

<A>: Thank you.

Operator: Thank you very much sir. Ladies and gentlemen, your next question comes from the line of Doug Anmuth of Lehman Brothers. Please proceed.

<Q – Douglas Anmuth>: Thank you. A couple questions. My first one is regarding – it sounds like you have a lot of things going on or that need to get finished, rather, by the June, July time period, like the warehouse build out and the new customer service application so I just wanted to get a sense of what your confidence level is that those things actually get done sort of by the time we really get into the back-half of the year? And then secondly, you gave some pretty – a rough outlook recently in terms of your – saying that you could do break-even or better EBITDA in operating cash flow for the year. Do those numbers still hold? Thank you.

<A>: Sure. I am just making notes. Okay. On the – on getting the customer service and mezzanine thing done. First of all, customer service, my confidence level is good on that, that we finish – it was actually suppose to be finished in early June but – so I am confident we can finish in June, unlike – it is an ASP model. We went with Right Now's ASP model, which greatly simplifies, I wish we had done this before, greatly simplifies the whole implementation and they have sent a first – first-rate team and I think that they – I think we will be one of their larger commercial clients and they are giving us a lot of attention and it is so far, it has been working out on a month – or six weeks, in my impression, is a very professional team and we have the resources. We are just getting much more organized so that when we do things like this, it is not grabbing a couple extra programmers and working on nights and on weekends, we are getting a lot of our increase is in technology, technology spend.

We are – we have just a lot more technologists and developers and such so it is getting to look more like a real company when we do things like this but if there is any doubts, I would say it is rRght Now, just because it is the nature of any software implementation, customer service app. You can always imagine that running over so I can imagine that running over. The mezzanine, no. The mezzanine is bolting things together. It is funny that you ask that. We actually had a – a truck full of important parts trucking in through – coming in from L.A. through Southern Utah ran into a cow and tipped over and that actually literally stopped the project for 2 weeks. But short of any more cows on the Interstate, we – I don't see how that gets delayed. That's just bolting things together.

As far as break even on a EBITDA basis, definitely if you're – I mean it would hard for us to break even on a GAAP basis but with 35 million of depreciation and amortization, adding that back in to the – I would imagine, yes, we should break even or do better. David, do you want to follow up on...

<A – David Chidester>: I think when you look at break-even cash flow we still think we can get there. If you look at the last 12 months we've – for the trailing 12 months operating cash flow is a negative 44 million. 31 million of that is just inventory. We're just a lot deeper in inventory than we were last year. We believe we can run the business with much less inventory. So if we can bring that inventory number down in particular, we do believe we can be break even cash flow for the year.

<A – Patrick Byrne>: Yes, one of the things – let me comment on that because we were – our electronic data warehouse, on the one hand didn't give us everything that we started off expecting from it, but what it did do is save our bacon during the whole ERP problem because as the ERP system sort of spewed everywhere we caught it all with the electronic data warehouse and it really saved us there. But we still have, I think 3 or 4 months left, and we have a very good – we've built an electronic data warehouse team. A lot of guys from Teradata and from other good companies, big retailers whose names you would know with a lot of good experience who are – it's all bolted together and it's been working, but I would say that if what we used to have in our home-grown systems was a 10 and our new systems, they're probably a 6 to an 8 in terms of our business intelligence, but I think they're on their way to a 15 or to a 20. And meanwhile our old systems that were on a 10 were failing, but one of the first things that they have done that's been very powerful is they've let us do much more sophisticated inventory analysis and we just see that we really think we should be able to squeeze a lot out of our inventory.

Now I think we show you – what do we show? 81 million ending the quarter? David?

<A – David Chidester>: Yes. Of inventory, yes.

<A – Patrick Byrne>: And now that includes 7 million of diamonds and I just had an offer last week to liquidate the diamonds. If I ever want to get out of them I can liquidate them at a profit. So we sort of think of our inventory separately from the diamonds. So there's 74 million. The next 74 million is already down. I wouldn't be surprised – it's already down in the mid 60s and I would imagine it ended the quarter in the low 60s and I really think that from the analysis we're getting now it may be possible to squeeze – well I don't want to overstate it, but I actually think that we – the analysis suggests we can squeeze several tens of millions of more out of the inventory now that we – with the business intelligence we now have. So in that sense the system actually pays for themselves.

So anyway, go back to Dave's point. Yes, we had a 43 million negative operating cash flow in the last 12 months. That's because we've gone from 50 to 81 and the inventory is – 31 million of that is just inventory creep.

<Q – Douglas Anmuth>: Can I also just ask you, you mentioned that there was something in terms of site redesign that gave you a 3% lift last month. Can you give us any more detail or insight into that?

<A – Patrick Byrne>: Sure, in fact, I'm so excited about it I'm – I hate to – I don't even want to give this particular company props. Because I don't want my competitors knowing about it. But there is a company we're working with that it's got some very cool technology. They actually, we're the only people doing this, but somebody else – somebody just started, a competitor, it's very sophisticated. It's called Genetic Algorithms and I guess I've probably just given that away. But Genetic Algorithms is a – the company is called Optimost and they come in and take a page and there's a lot of set up time, but they take a page, say, our product page and say here's 5 or 6 different ways I could have the button placed. Here's 5 or 6 different ways I could have this placed, that placed. And in a sense – so they take a subset of your traffic.

They – now all those different billions of permutations of the 20 different variables with 5 or 6 ways each that they could be set, there's billions of permutations. So they run a test of a subset of your traffic for say a week. You get – then do a multi-variate reggression finding, say the best 8 factors. They sort of mate them all together, hence the Genetic Algorithm, they mate them all together and create 1,000 offspring. And then they take that and you see – test that after a week and at the end of the week, you take the 8 most fit offspring and you mate them together and you get another 1,000. You do that a few times and so – it evolves into the right combination. And we actually – we think that there's – we're doing that one product page – one page at a time. It's basically 6 or 7 major pages in our website; the product page, the home page, department category, sub-cat, store, department and we're going to sort of do that each month page by page.

I guess it's not really a secret, but I do know that other big names in this field – other big names in the industry have their own teams. So I haven't really – it's not like I'm giving Amazon a secret. In fact, I know that there's a guy from Amazon, the Chief Scientist, is the guy that set up – the former Chief Scientist, I believe, is the guy that set up the competitor to Optimost. So this is a sort of leading edge area. The gains in it seem pretty substantial and so we're just going to be doing one – but there's a lot of set-up time for each one of these tests. Doug, I hope that wasn't more than you wanted to know, but...

<Q – Douglas Anmuth>: No, very helpful. Thank you.

<A – Patrick Byrne>: Thank you.

Operator: Thank you very much, sir. [Operator Instructions] Our next question comes from the line of Scott Devitt of Stifel Nicolaus. Please proceed.

<Q – Scott Devitt>: Thanks. Two questions. The first on accounts payable in the quarter. The pay down was 64 million, was up, I think, 170% year-over-year. I'm wondering if – what the explanation is, whether – if it is related to any changes in terms either with suppliers on the direct inventory or in terms of paying partners more quickly on the commission side? And then I had a follow up.

<A – Patrick Byrne>: I can – David, why don't you start off and then I'll chime in.

<A – David Chidester>: Okay. You know a lot of that is just a reflection of the slowing growth. Because, you know we are still paying partners the same we've always paid them. We are a little bit ahead on paying partners just because we had some billing issues with the new ERP system, and so we've sort of stayed ahead of the game. Make sure we are taking care of our partners and we've actually paid a few extra days then we've normally would have had. So, that accounts for a few million of it. But, in general as growth has slowed and the mix of our business moves more towards the core business than the partner business last quarter. EDT accounts payable go down more than average historically.

<A>: Yes, there is a – we because of the ERP problems we reached a place where it was hard for us to pay precisely. We have been fanatics on paying our partners – I mean our daily instructions since the first days have been we always pay our vendors. I want to have the best reputation with them. Because, that's the nature of the close out business. And vendors or partners, and in fact we went from – about a year and half ago, we went to paying them electronically. So, it saved 5 to 10 days, because we didn't have to wait for the mail. We started with these little – electronic checks, which they love.

When we started having these problems last fall. I said to David, lets pay the high-side of whatever we think we owe them, at the end of every two weeks. So we actually got a lot of cash in front of some vendors. And then in the first quarter as we've been able to sort of tune in and recreate exactly – and reconcile sort of more to the penny. We've – it was just good sort of a karma to always pay. We weren't able to count in the payments we were able to count at our end. But not for them to reconcile exactly the returns that we had to deduct. So, we always just paid them extra, and then – so that has just started to come back to us now. Actually now, we can pay them precisely to the penny.

But, in the first quarter we were still ahead a little bit. We have had some funny things happen. Some of it blaggered [ph] in this case one of the major prime brokerages had actually gone to some of our partners and tried to get them to stop. Which tries to raise doubts about us and they seem to be trying to submit [ph] a run on the bank kind of situation. One of the three top guys, hopefully not obviously [indiscernible] close but, so they are out there. Trying – going to go to our partners, and trying to, because we have actually had one major, major partner call and say you can't believe the call I just got from a one of their bulge bracket banks trying to get me to shut you off.

<Q>: And just a follow up on the direct gross margin, it was down 300 basis points and I think Patrick in the letter you noted warehouse costs as being one explanation and I'm wondering because the inventory level was high coming out of 4Q, what component of that was pricing just to drain inventory levels as well?

<A – Patrick M. Byrne>: There's definitely a piece of that in the first quarter and there'll be a piece of that in the first part of the second quarter although we've come out of it now but we did mark things down in order to flush things through so that hurt our margins.

<Q>: Okay thank you.

<A – Patrick M. Byrne>: Thank you.

Operator: Thank you very much sir. [Operator Instructions] Our next question comes from the line of Frank Gristina of Avondale Partners. Please proceed.

<Q – Frank Gristina>: Thanks, guys. Back on the direct business, was free shipping involved at all in the volatility? And just to review the direct business, it seems to have a lot of volatility, even year-over-year in the gross margins. And I guess pricing, warehouse costs, is shipping an aspect there? And then building on that, you don't seem to have the volatility in the fulfillment business so, why wouldn't you just open the doors to fulfillment partners and really try to make that business larger in the mix and drive your margins higher?

<A – Patrick Byrne>: Okay. I'm going to take that and then – David, do you want to go first?

<A – David Chidester>: I'll just comment quickly, Patrick, and then you can finish. Part of the reason the direct business has more volatility is that we have our B2B business. We have some core BMV, Books, Music and Video, that has lower margins so as those businesses move and sometimes the B2B business is more moving inventory out, maybe slower moving, lower margin, so depending on how the BMV business, core business and B2B businesses move, that can have an effect on the overall margins. So the direct does have some more moving parts than the partner business does.

<A – Patrick Byrne>: Although I would say, how I was going to answer, Frank, was that the pricing is the biggest element in the volatility. The shipping is an element as well although we're cutting back on the free shipping. We're not using that as extensively. The smallest element of the volatility is the warehouse handling costs. Now I do think that we're going to be able to take a nice sliver out when we get this new mezzanine finished but it's not like suddenly the warehouse got running – started running badly. It was much more pricing and changes in our shipping policies and how often we give dollar shipping and things like that. As far as partners, we've built to 700 partners. We're about to have a – I think, a way to increase that several fold if we want.

<Q – Frank Gristina>: Is there any reason why you wouldn't want to? You could still own the customer but just not have to deal with these warehousing and shipping issues?

<A – Patrick Byrne>: No, there's no reason we wouldn't want to. There were reasons in the past and that was we were less confident of our customer satisfaction from partners than we were of ourselves. We now have ways that we're able to measure that as of a week ago and we can, in a – the middle of May, if we want, we can increase our total number of partners about fivefold. I don't think we're going to increase it fivefold. We don't want to be Yahoo! Shops. But we are I think on the verge of filling in – we don't want people just to compete with current partners but we think we can fill in – we are not going to increase it fivefold but we will have our pick of increasing it in areas where we have not been selling products yet or have had a very sparse selection, we'll be able to increase it with partner products. So – but, I'm not sure I would see an overall – other than in those sparse areas, we'll get filled out. What we're also learning is not to have too many products. We don't want to – we wonder now if we may have too many SKUs and we certainly have discovered that the 20/80% rule is even a – anyway, we're not trying to overwhelm the customer with choice anymore. We're trying to refine it to the best choices.

I have a – Jason is on the line and Jason, as you know, was named President earlier this week. For the old timers here, Jason was – I think Jason – I think everybody regretted when Jason retired a few years ago. And but I know Jason has some strong thoughts on this. So, Jason, why don't you come on the line and answer – first of all, tell the world why you left and why you're back if you want to and how do you feel about this? Because I know you have a lot of thoughts on this question. Jason?

<A – Jason Lindsey>: Hello, can you hear me?

<A – Patrick Byrne>: Yes.

<A – Jason Lindsey>: Well to answer the question first, why not just open it up to everybody? I think the answer is, as Patrick said, we don't want to be Yahoo! Shops. There's a trade off between selection and clutter and that's a fine line, which we spent a lot of time lately looking at and we're going to try and hit that line as close as we can. I think you will see more partners come online soon, especially in areas where our selection is limited.

As far as why I left, I left for the reason I said I left. I had health problems in the family. My wife got...

<A – Patrick Byrne>: You don't have to go into all that if you don't want to.

<A – Jason Lindsey>: Yes. So I had real health problems in the family, spent a lot of time in the hospital with the family, but everybody's doing great and I'm happy to report everybody's fine and has been for awhile. So I'm anxious to be back and it's good to be back.

<A – Patrick Byrne>: Jason has actually been behind the scenes here the whole time in the sense of one day a week coming in and helping at the – co-presiding with me. He's always really been my co-CEO, really, since we started the company. And we've just made it official this, I guess – when he came back full time, basically, for this year so far. And will be full time going forward.

Okay. Anything else, Frank?

<Q – Frank Gristina>: No, thanks very much.

<A – Patrick Byrne>: Thanks. And that's – we love the partner program. We've – we're starting to love it more even. So, okay, Operator, next question? I think we have time for one more question.

Operator: Thank you very much, sir. And our final question will come from Derek Brown at Pacific Growth. Please proceed.

<Q – Derek Brown>: Thanks. How much cash do you think you'll need to re-ignite growth for the fourth quarter and when do you need to have that cash to build inventory and make sure that the store is filled and the stocks – the shelves are stocked?

<A – Patrick Byrne>: Well, I'll – my answer is I don't think we need more cash. I think that we can go into – I think that we can run our inventory much better than we did before. So in the fourth quarter if we – what we have now is probably the right amount to enter this fourth quarter with. We don't – we have built it up too much in the past is what we've learned. Jason, what is your – I'm sure you have an additional...

<A – Jason Lindsey>: Sure. Hey, Derek, long time no hear. I think we have plenty of cash as well. One thing we learned, obviously since we have way too much inventory now, is we went through the Christmas season last year with way too much inventory. So if you look back and calculate any accounting of ratio of how much inventory do they have going into the season and how much do they need, the season being the Christmas season, you'll see that, like Patrick said, the inventory we have on hand now is probably plenty. So we don't really need a bunch of additional excess cash to build our inventory levels. But I will – I do say that I think you'll see over the next few months we will continue to buy more inventory and sell more inventory so our mix will change but I don't think we need a bunch of cash to build our inventory levels.

<Q – Derek Brown>: But would you agree Jason that it's going to decline and then swell up again in September, October?

<A>: Yes, absolutely.

<Q – Derek Brown>: Great, thank you.

<A>: I guess we do have time if there's, is there anyone else Operator?

Operator: Actually that was the last question sir. We're going to turn it back over to you for final comments.

<A>: Okay, well as I said, Jason, do you – why don't you make some final comments.

<A>: Well my thoughts from 30,000 feet are we stumbled and we know we stumbled and don't let anything we say think we're making excuses or we don't realize that we stumbled. However in the long run it might be a good thing for the business. We grew 100% last year – or something close to that, year after year after year and when we had the debacle we had replacing all of our systems this year, it's – obviously we shrunk a lot and when you shrink that dramatically, that quickly, your financial results look terrible. But it is given us a time to take a deep breath and harden all of our systems.

Historically when we were growing that fast in the past we were trying so many things and launching so many new businesses, the thing I'm encouraged about right now is everything that we're focusing on and everything you hear us talking about are all hardening and building the infrastructure for our core internal shopping business.

You haven't heard us say anything about any other business other than Overstock merchandise to our customers and that business is getting a lot of attention. It's getting more attention now than it's ever gotten and as bad as the system's got, I think Patrick mentioned before when he was talking about our aggravation points, I think the core shopping business as far as somebody orders a product and they get it on time, I'm not sure that our business has ever been better and now we're spending all of our – so from the customers side it's better than ever. From the investor side, the financial side, now we're spending an equal amount of time making sure all the internal systems to make us manage our business and have it be as efficient as it can just for the core shopping site. It's getting that attention now.

So I think investors should be pleased and in the next 6 months to a year you'll see a big difference in our financial performance because of it.

<A>: We went, thank you Jason. We went a long way on a thimble full of systems and I blew it, I should have realized 6 months earlier than I did that those, when those systems reach their limit, they were going to reach it at there – they were going to work until the day they didn't and then they really didn't work.

So to me this is all a function of bad decisions I made in the first half of '05, both in that they were belated and then I made a bunch of them and we tried to throw a bunch of stuff together and we stumbled and it's kind of, it's taken us the first quarter, the second quarter and we all might as well assume the third quarter to pick ourselves up and dust ourselves off and get going.

We, and to Jason's point about what the – one of the things we get so excited about is we realize now that it's like the Japanese teach this way of thinking in manufacturing that you drain the reservoir until some rocks emerge and then you go and you blast the rocks and then you drain the reservoir some more until some rocks emerge and then you blast those rocks. We had drained the reservoir all we could on our old systems in the sense of we couldn't have gotten better. We couldn't have gotten better or more refined looks at inventory or more refined looks at marketing, and we certainly couldn't have done analytics that underlies personalization and so forth. We couldn't' have gotten any better than we were. Yes, but there's these transition costs. We've moved to a bunch of big honking professional systems and off this sort of stuff that was duct-taped together but there's transitional costs, but now that we're on it we can drain the reservoir a lot lower than we could have under the old system in terms of fixing problems and such.

Jason [ph] pointed out we didn't even mention the other tasks. I will mention that Travel beat budget for the quarter. Auctions was just a little bit behind budget. Last year we lost nearly 5 million in Auctions and the goal this year is to again break even and I think we should come within at least $1 million of that goal in Auctions. And we don't really have any new, any great new businesses planned. We're just refining what we have.

Dr. Patrick M. Byrne, President

Okay? Well thank you for sticking with us, the long-term owners, and I'm sure like me you welcome having Jason back to provide adult supervision. Look forward to talking to you in 3 months and again expect pretty much the same thing, expect pretty much the same thing for one more quarter and then things will start getting better in the third.

Thank you. Bye bye.

Operator: Thank you very much, sir. Thank you, ladies and gentlemen, for your participation in today's conference call. This concludes your presentation and you may now disconnect. Have a good day.