

FINAL TRANSCRIPT

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OSTK - Q4 2007 Overstock Com Inc Earnings Conference Call

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CORPORATE PARTICIPANTS

David Chidester

Overstock.com - SVP, Finance

Patrick Byrne

Overstock.com - Chairman & CEO

Jonathan Johnson

Overstock.com - SVP, Corporate Affairs and Legal

CONFERENCE CALL PARTICIPANTS

Nathaniel Schindler

Merrill Lynch - Analyst

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the fourth-quarter and fiscal year 2007 Overstock.com earnings conference call. My name is Lacey, and I will be your coordinator for today. (OPERATOR INSTRUCTIONS). As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to our host for today's call, Mr. David Chidester, Senior Vice President of Finance. Please proceed.

David Chidester - *Overstock.com - SVP, Finance*

(technical difficulty) -- our press release in front of you since our financial results, detailed commentary and the CEO's 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 purposes of the Safe Harbor provisions under the Private Securities Litigation Reform within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities 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 in 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 materially 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 Form 10-K, 10-Q, 8-K and S-1.

I will now review the financial results first for the quarter and then for the year ending December 31, 2007. Please refer to our earnings press release for the full financial statements and further details regarding our results.

All comparisons will be against our results from Q4 2006 or from the full-year 2006 unless otherwise stated. I will begin with a summary of Q4.

Total revenue for the quarter was \$300 million, up 2%. Gross margins were 16.3%, up 700 basis points. Total operating expenses were 21% -- or down 21% to \$54 million or 18% of sales. Our net loss was \$4.3 million for the quarter or \$0.18 per share compared to a net loss of \$41 million or \$1.95 per share. We generated \$2.2 million of EBITDA, and that makes two consecutive quarters of positive EBITDA. We also generated positive operating cash flow of \$56 million, and that is up \$4 million.

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Now for the full-year 2007 results. For the year we had total revenue of \$769 million, down 2%. Gross margins were 16.8%, up 480 basis points and up 220 basis points from our previous high in 2005. Our direct margins increased to 16% for the year from a previous high of 13.2, and fulfillment partner margins increased to 17% from a previous high of 15.7. And these improvements come primarily from more disciplined buying, but also this is combined with 150 basis points of improvement and fulfillment costs, particularly from reducing warehouse handling and customer service costs. Total operating expenses were down 10% to \$170 million, and this equates to 22% of sales, which is a 200 basis point improvement. Within operating expenses, sales and marketing expenses improved 180 basis points, and tech and G&A costs improved 100 basis points.

Our net loss was \$44 million, which represents a \$58 million improvement to the bottom line this year, and it represents a \$61 million improvement if you exclude restructuring and discontinued operations from both years' results. We ended the year with \$147 million in cash and cash equivalents. That is up \$20 million for the year, and we had \$10 million of positive operating cash flow and over \$7 million of positive free cash flow for the year.

And with that, I will turn the call over to Patrick.

Patrick Byrne - *Overstock.com* - *Chairman & CEO*

Thank you very much, Dave, and we are also going to be joined by Jonathan Johnson. I'm going to walk through the slide, and I cannot advance your slides, so I will just tell you please go to slide three.

Again, it highlights 2007 was the turnaround year. I have had the pleasure of building or we have had the pleasure of building a near \$1 billion business, me screwing up a near \$1 billion business, and my colleagues fixing a near \$1 billion business. We think we're back and in the groove.

Our operating cash flow was positive, free cash flow positive trailing 12 months. Historical best gross margin, contribution margin again historical best. I recently found out that we repeated our position National Retail Federation and American Express survey of American households named us number four in customer service in America. We had a great increase in product selection this past year.

Slide four, I mentioned -- well, I know I said several times a year, a year and a half ago, that the turnaround prediction, that turnaround was going to look like this. We are going to start as close to the bottom of the income statement as we could, and that meant getting the contribution dollars, contribution profit turned around. That is gross profit minus marketing. You see that return to growth or hyper-growth. Then you would see growth in gross profit dollars, and only last did you see revenue growth accelerate (inaudible).

The slide you are looking at, slide four, shows revenue has still not accelerated. But go to slide five and gross profits grew in 2007 at a healthy 36% clip, and slide seven shows that contribution profits actually tripled to 100% growth. That is exactly as we predicted it would come. We actually feel -- I feel great about that.

Of course, the contribution cannot continue growing at that rate. All of these numbers are going to converge, and you can imagine in a perfectly steady-state world and if this was an old industry, everything had reached its equilibrium point, these all would have converged to basically the same number. I'm not going to tell you what the number is, but I do think that those all converge to a range this year. So the 207 will not be coming down, but I believe the negative 2 will be going up.

Dave, do you have any comment?

David Chidester - *Overstock.com* - *SVP, Finance*

Nothing to add.

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Patrick Byrne - *Overstock.com - Chairman & CEO*

Alright. Let's go to slide seven. Gross profit, all-time high, \$128 million and 16.8%. So up 4.8% from the previous year, up a couple of percent, 200 basis points from 220 basis points from '05.

In the fourth quarter, there is such a surge in media, and C&E -- media means books, movies, music, games -- and both of those categories are low margin. In the past we did not have much C&E to speak of, computers and electronics. This past year we did. And we have a much better -- we have a real C&E department now, and it is growing very quickly. And, as a result, I would say our margins came down a little bit more than we thought for this fourth quarter surge, but that's a reflection of this big growth in electronics. Dave?

David Chidester - *Overstock.com - SVP, Finance*

Yes, and I think it is also a reflection of increased discounts and coupons that we did see in the fourth quarter. It was quite a competitive and promotional quarter across the industry I think.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Yes, that is true too.

David Chidester - *Overstock.com - SVP, Finance*

And I would just add to what you are mentioning of gross profits improving, I think we have talked a lot in the past about all the improvements we were going to make to merchandising and buying and being much more disciplined, and we did that, and that is why you do see a lot of that improvement relates to that and just our basic inventory management.

But I think it is worth calling out that 150 basis points of this improvement came from operations, and we are not growing. And so these are not volume efficiencies. We actually, 150 basis points is, \$12 million of our expense structure within warehousing and customer service we cut this year while maintaining the top four customer service. So it is not at the expense of providing great customer service. We have just become much more efficient.

Patrick Byrne - *Overstock.com - Chairman & CEO*

That is a great point. And we rationalized our infrastructure, but also have just gotten that people running customer service and the warehouse and logistics have just gotten so good I think at their jobs and so efficient that they are really -- we went from the phase where we're picking up \$20 bills laying around the warehouse to \$5 bills to \$1 bills. And now I still think that there are quarters and dimes they can pick up. But they don't have -- and the same with customer service. They have just gotten -- we measured -- we have a great partner in RightNow, which has given us a lot of good technology we use to measure people, measure productivity and measure satisfaction. And just the managers throughout those two parts of the company have gotten very adept at their jobs.

So again, I'm going to jump on that point. 150 points of this is just increase in operational efficiencies that was not obviously brought about by scale because we are not growing.

Okay, slide eight. Contribution, 9.5%. Q4 was 7.2%. It still was an increase for the year of 6.5%, and the previous best had been 2005 at 5.2%. So we still went from our previous best 5.2 to 9.5. And even the 9.5, a little disappointing that we came down as much as we did in the fourth quarter. I'm sure we will be talking about that in Q&A. And without that, I think we would have been over 10.

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Dave, do you want to say anything about that?

David Chidester - *Overstock.com - SVP, Finance*

Well, I would you say that we talked about the 220 basis point improvement in gross margin. That's about half of the improvement in contribution. The other half comes from more efficient marketing, and we basically cut 20% of our spend this year, and yet we only shrunk 2%. So that's a reflection of our marketing dollars being spent and becoming much more efficient.

Patrick Byrne - *Overstock.com - Chairman & CEO*

And even that is with what I think of as in the fourth quarter, I will say now because I'm not sure there is an appropriate slide for it that would be more appropriate. But in the fourth quarter, we built quite a marketing ski jump. And we probably -- I built it to -- I built it at a little bit of a rush partway through the quarter, and the sky jump was probably not exactly the optimum shape, and it was not placed exactly on the ski slope in retrospect where it should have been.

So what that meant was we did not get the optimal amount of air in the fourth quarter, but it launched us into the first quarter with a fair bit more momentum than we had been expecting.

Okay. Move on to slide -- anything else you want to say on this?

David Chidester - *Overstock.com - SVP, Finance*

No.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Slide nine, operating expense. It came down \$20 million '06 to '07. It went from 23.9% to 22.2, so it picked up 1.7 there. I expect this year, without getting too precise, I would say that you can expect this 169, \$170 million to be flat or slightly down. Do you want to qualify that in any way?

David Chidester - *Overstock.com - SVP, Finance*

No, I would just say we do have this year and next year quite a bit of depreciation expense dropping off. So I do think we can continue to invest in the business without increasing our operating expenses, and that is the nice thing is that we -- it is not that by keeping expenses flat we're cutting things that we need to innovate and to make the business better. Fortunately we've just made a lot -- we made such big investments in the past that we are not having to do as much now, and therefore, even keeping operating expenses flat, we're able to invest in the business.

Patrick Byrne - *Overstock.com - Chairman & CEO*

The truth is even without -- if there were no growth, if we continued with no growth, I would expect this to be somewhat down. But what is more likely or more on our agenda is that this will be flat but supporting a return to growth.

We're investing in projects. Unlikely in the -- slowly and reluctantly we have become a technology company. And we have always been at the beginning four or five years ago, our public life, I was always saying we are a lemonade stand with computers. We do not think of ourselves as technologists. We have built quite a tech team with the help of some of our partners out there life Teradata and Oracle. But we have built a very solid tech team who is able to take on -- it is no longer the bane of our existence.

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Arbitraging or choosing among different absolute necessary tech projects. We now have enough technologists. We are actually able to come up with new ideas, get them built without waiting months or a year or two or something.

So we're replacing some of this depreciation or some of the depreciation that is falling off is being replaced with cap expense in the form of we're hiring a lot of developers and Q&A and architects. And most of that, though, is for new projects we're doing. And they are enhancements to our existing business. They are making our site better.

Do you want to mention that all -- this might be an appropriate place, Dave, what your thoughts are on CapEx?

David Chidester - *Overstock.com - SVP, Finance*

Well, we spent only \$3 million this year, and that was all basically software, new projects. That was not hardware. And I think we do expect that number to go up moderately, probably closer to \$10 million this year. That will include new projects and some systems upgrades. But once again, I think most of that will be just enhancements and improvements to the business.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Now we do not have any big -- we don't even approach projects now from the point of view of great big capital or infrastructure investments. I have got to say Teradata, and this is such -- they have been such a good partner, I would be remiss not to mention them, although it is -- anyway, I feel like I'm giving away an internal secret. And that is that by having switched to Teradata and the data warehouse model, it means so many things that we used to do with capital expenditure and people can now be reduced to algorithms within Teradata. And we just have found amazing uses for it.

Okay. Moving onto the next slide, the next slide 10, operating leverage. A year ago we were growing 41%. Our operating expenses. Now we're shrinking 21%. That is quite a change in one year. Great work from Dave and Jason and people throughout the Company on getting very -- getting their fingers around our expenses and building some very good expense control systems. Dave?

David Chidester - *Overstock.com - SVP, Finance*

Yes, I think we're finally in a position now that with growth we will leverage. And it was just really difficult to get there when we were growing 80, 90% a year and always having to build ahead of that growth. Now it feels like we understand our expenses, and if we do grow, we just don't need to add costs like we did in the past.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. Let's move on, slide 11, EBITDA. Note this is not EBITDAR. That would be restructuring. We do -- I have said for years I am not a fan of EBITDA as a general measure of things. The only time it matters is well, it mattered when we were low on cash and getting lower. It also matters when you don't have much CapEx. And since we have so little CapEx, it is actually a pretty good -- it is a close measure of our cash cash flow.

EBITDA returned, you see this terrible '06, which will go down in Company history, where we went from being actually positive EBITDA in '04, minus \$5 million in '05, earthquake in '06 and back to minus \$4 million in '07. And of that \$4 million loss, \$10 million is not discontinued operations but restructuring. So Dave, what would you like to add to that?

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David Chidester - *Overstock.com - SVP, Finance*

No, just that excluding that, those costs count. But if we looked going forward, assuming those costs are now behind us, that's a positive EBITDA year, and we anticipate in the future having positive EBITDA years going forward.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Exactly. Okay, next slide, slide 12, my favorite. Cash flow. You see that we had positive operating and free cash flow back in '02 and in '04. These terrible '05s and '06s. '07 we got positive again on both of them, and again, that is with -- that was still a turnaround year. And the difference between the two, the \$10 million and \$7.3 million, is the \$2.7 million we spent on CapEx.

And again, \$10 million is a good number for this year. It is a little bit higher than we have actually budgeted for this year. But we do intend to reinvest now \$10 million in the business, and to Dave's point, it is not -- it is mostly development of new projects.

The next page. Add to this, Dave, it is certainly our goal to be free cash flow positive from here on out.

David Chidester - *Overstock.com - SVP, Finance*

Yes, I think free cash flow is a number that will mean more going forward to us than probably EBITDA. And because in the end, we don't want to burn cash at this point forward. And so I think that will be a good indication of taking dollars, reinvesting in the business. We think that we can do that and still keep free cash flow positive.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay, slide 13. The gross margin return on inventory is 124 just from the core business, and it's over 500% for the business as a whole.

Slide 14, inventory. And that is explained by the fact that we have just gotten far better at running our inventory down from \$101 million two years ago to \$28 million -- I'm sorry, I'm on slide 14.

I should also mention that this \$28 million is far better allocated than the \$22.5 million was from last year. The \$22.5 million we're still -- we have come out of things, and it was selling products. We had liquidated all of our slow or most of our slow sellers. But it was still -- this \$28 million is much more scientifically allocated. We have very good systems now for getting down certainly to the subcat and even to the SKU level, and just running our inventory much better. So our turns are running on a GAAP basis over 25. Dave, would you like to add anything?

David Chidester - *Overstock.com - SVP, Finance*

Nothing to add.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Alright. Next slide, 15, our net promoter score. These numbers are for the competitors are out of (inaudible) book the (inaudible) question, it says, the average American company is at 8%, and the superstars are in the upper right there from Harley-Davidson to AmEx. And we measure ourselves -- well, it is a third-party does it for us, but we run at 69%. Interestingly, even people who contact us who have a problem, their MPS -- this is measure of satisfaction -- their MPS is 14%. So it's higher -- so even people who had a problem contacting us were higher than the average American company. And overall we as a company scored 69.

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So we have this fanatic -- I will mention the National Retail Federation and American Express, they do this poll each year where they call up 10,000 households and they say, who gives you great customer service? And we were -- I was just back in New York a couple of weeks ago. We were for the second year in a row named number four.

Ahead of us, number one, was I think L.L.Bean. I forget who number two was. Number three was -- say again? Two was zappas.com, and three was Amazon. So we are now one step below Amazon on that scale. And we are -- we have our eyes on this year.

So anyway, I'm -- I think this has -- coming out of the ditch we were in, we're not even in the top 150 as I recalled a couple of years ago when we had all those problems. And to be out and be number four two years in a row is a great tribute to Stormy Simon, and she was joined in the year by Steve Tryon. They did a wonderful job there.

Slide 16. I know by the way Steve would say, Stormy gets all the credit, but Steve was certainly there for part of it. We have a really good customer -- we have made customer service not just the linchpin, but it speaks to the whole Company to many of the changes. Many of the improvements of the Company are actually driven from our customer area partner. We view them as speaking to the entire Company and giving orders to the whole Company, that we've got customer-centric so quickly.

Highlights of the year, page 16, slide number 16, was again just all-time high in gross profit, gross margin, contribution, profit contribution margin. Both came back much quicker than I think anyone would have anticipated a year ago that we were going to be able to get that those fixed. I'm particularly proud of the contribution profit in '07 going to \$75 million, up from \$23 million I think it was last year. And even the high before that, before things came off the rail was 40 million. So we got things fixed pretty quickly.

Inventory turns. We are running our inventory far more efficiently. And EBITDA and EBITDA margin came back almost to breakeven, actually over breakeven without the restructuring.

Okay. I'm going to -- so anyway, it was the last couple of years as our followers have known we're pretty tough. There were some doubters there. We did come off the rails, and we had to make some very -- we had to work hard to make changes that would get us back on the rails. And that was '07, and I'm pleased with how quickly my colleagues were able to react and make the changes that had to be made.

Now, I'm going to do something different here in that I am going to break and call on my esteemed colleague, Jonathan Johnson Esquire, who has our SVP for Legal and Corporate Affairs to talk about --

Jonathan Johnson - *Overstock.com* - SVP, Corporate Affairs and Legal

Thanks, Patrick. Patrick has asked me to give a quick update on our two litigations suits out in California.

First, our suit against the prime brokers. We had some nice progress there over the past four to five months. Prime brokers have tried to get that suit dismissed, and the trial court judge denied their request. They then petitioned the California Court of Appeals to get it dismissed in a little bit of a desperate attempt we thought, and the Court of Appeals again denied their petition.

So that case is going forward. We have been through one round of discovery. The judge is managing the discovery carefully, and we are about to start our second-round, which for us feels like the time when we're going to begin to get into the mother load of data, and really hit -- throw a good shot across the bough.

Patrick Byrne - *Overstock.com* - Chairman & CEO

Which we intend to do is to get into the mother load of data.

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Jonathan Johnson - *Overstock.com - SVP, Corporate Affairs and Legal*

Absolutely. Absolutely. So we are -- we think we're moving forward at a nice clip on that case. And the Rucker/Gradient case, which has been pending for a much longer time, the trial court, the Court of Appeals and the California Supreme Court have denied all of Rucker and Gradient's motions to have that case dismissed. And we have started discovery and will begin exchanging data shortly.

I will note that Rucker, now known as Copper River, has filed a cross complaint against the Company and some of its current and former directors. That is perhaps the most frivolous suit that I have ever seen, and we expect to hunchback hard and get that case dismissed. So that is an update, Patrick.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Thank you, Jonathan. He gets mad when I say thank you (inaudible). But we feel very good about those lawsuits. And if you're not following them closely, if you're just reading what, you know, the hedge fund shields would have you believe, they are not giving a very accurate picture of how much progress is being made in those cases. In fact, if you are interested, read the appellate decision of the Rucker case, which was a very clear analysis of the real issues implicated as opposed to what their favored journalists were to describe the case as being about. And in a paradigm, which has incidentally now has been rejected, eight to nothing, eight counts to nothing at the (inaudible) level, the appellate level, the Supreme Court, refused review, etc. But it is still a paradigm within which some of the journalists are reporting that case.

Okay. With that background, let's see anything else you want to say, Dave, before we go to questions?

David Chidester - *Overstock.com - SVP, Finance*

No.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. Operator, why do we go to -- I do have some questions here, Dave, from [Matt Drury], [Harbor Island Capital]. Do you have those in front of you?

David Chidester - *Overstock.com - SVP, Finance*

Yes.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Why do you -- I will read the question, you give the answer. Can you explain the types of marketable securities held on the balance sheet? Is the \$46 million in excess cash the Company estimates it will not need to use to pay partners or to build working capital as the year progresses?

David Chidester - *Overstock.com - SVP, Finance*

The answer is, yes, that is excess cash. The reality is in this current market with rates in a market where rates are being cut everything is being kept very short-term. And even those things that are classified as marketable securities have terms of sort of four months or less. And so nothing has long maturities at this point in our portfolio.

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But once all of our cash sort of settles this year, we will sell with 90 to \$100 million, and having 40 of it in marketable securities getting a little bit better return is probably about the right number.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. Is the \$2.7 million in CapEx sustainable? Dave, I'm calling on Dave -- (multiple speakers)

David Chidester - *Overstock.com - SVP, Finance*

I think we addressed that. We are intending to spend more in the future.

Patrick Byrne - *Overstock.com - Chairman & CEO*

It will be close to \$10 million this year, but below \$10 million I think. But still it is probably a good number to plug in. Breakdown between hardware and software spending?

David Chidester - *Overstock.com - SVP, Finance*

Again, this year it was primarily all software, and I think this year we will have a big piece of it will be software again.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. [Mike Ungay] asks, how many shares did you buy back in '07 and year-to-date '08? I think the answer to both is zero.

David Chidester - *Overstock.com - SVP, Finance*

Well, in 2007 we did not have a buyback program. We only implemented it just now early in 2008, and any buybacks that we would potentially make would be disclosed in that quarter's filings, so.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. Operator, we can go to questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Nathaniel Schindler, Merrill Lynch.

Nathaniel Schindler - *Merrill Lynch - Analyst*

A question about the marketing spend in Q4. It happened late in the quarter. We were kind of told of it coming into around November. It seems a little late for a quarter that represents, what, 40% of your gross booking, and most retail companies tend to plan their marketing spend for the Q4 long in advance. What prompted you to do it at that point, and was that an effective use of cash?

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Patrick Byrne - *Overstock.com - Chairman & CEO*

The thing that prompted us to do it was just we felt that we had the Company fixed and had some input or had some feedback that suggested really not we were being too conservative in our spend and some data that showed we're being too conservative, and the market was ready for us to come back and hit harder and start really pounding into the American consciousness this combination of the best pricing on the Internet and fantastic customer service.

So we realize somewhat belatedly that we had been extremely conservative there, and we are probably leaving money on the table. But because I was belated in recognizing this, the curve that I built for the quarter, which we only decided some weeks into the quarter, and we put out the announcement as soon as we changed our minds about things. That curve was not the most perfectly designed curve. Well, as I've said upfront, it launched us into the first quarter with a fair bit more momentum than we have seen in a couple of years here. But if net net, it was not a -- for the fourth-quarter results alone, it was not terribly well-designed. But we seem to be getting back some of it from the momentum which had launched us into this quarter.

Dave, do you want to add on that?

David Chidester - *Overstock.com - SVP, Finance*

Well, I think the data showed that we had -- you know, overall we have had branding campaigns running. We tried different strategies, and I think last year we cut too dramatically during the regular part of the year, and then probably spent too dramatically in the fourth quarter, and we anticipate going forward to -- we had marketing down to 5% of sales. Well, we anticipate probably not getting that low this year, but having a much more consistent spend throughout the year. And then I think we will not feel a need to push things so hard in the fourth quarter like we did this year. So I think we learned from that, and I think we have probably a better strategy going forward into 2008.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Yes, it was pretty -- I'm afraid to say it was pretty -- well, it was a last-minute decision, and we made a bunch of changes, and the changes were not as optimal as they would have been if we had decided on that strategy earlier.

I will mention it was -- I view what happened in the fourth quarter as really -- there is three factors. One is there is just some secular factors of which everyone you can read the newspaper as I can or better. And there is something was going on in the retail world.

Secondly, there was a lot of heavy discounting of very competitive discounting going on. But third is that curve we added, not just with television spend, but we really did a lot of couponing as well. And that shows up -- I think that that decision probably cost us a little bit more even than the television decision.

So yes, we were also up against a strange period. In the same period in '06, we had what we called project flush. We had this new system of managing our capital, our inventory down to the SKU level, and it was not really totally refined in '06. But it was in place in '06 to the point that by the fourth quarter we were able to identify from a new perspective what we had been, where we were too thick. And we sort of changed the whole way we managed inventory, reserved inventory, everything like that. And as we did, we flushed down \$80 million worth of inventory in '06 in the fourth quarter.

And so we were really, really discounting in '06, which meant that we were just up against a strange period. We were up against our comparable, was it, period where we were just nearly giving things away. So that introduced -- that is one of the elephants moving around in the dark is that we don't know quite what to make of the weeks that we were up against. Dave?

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David Chidester - *Overstock.com - SVP, Finance*

I think that is a good summary.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Let's go on. No other questions?

Operator

(OPERATOR INSTRUCTIONS). Nathaniel Schindler, Merrill Lynch.

Nathaniel Schindler - *Merrill Lynch - Analyst*

Patrick, just to follow-up on what you said about what you saw and what we can all read about in the papers on the retail environment in Q4. I would really like your opinion, as someone who is a lot closer than us who can just read the papers, on what is going on in the retail environment? What happened in Q4 and what you see in Q1, and what that means for -- a recessionary environment means for Overstock?

Patrick Byrne - *Overstock.com - Chairman & CEO*

A couple of great questions. One, well, I understand yesterday -- correct me, if I'm wrong -- that Wal-Mart came out and basically said we have overbought, and we're going to drop prices 10 to 30% in our stores. Did you hear that, Nathaniel?

Nathaniel Schindler - *Merrill Lynch - Analyst*

No, I did not catch it, but I was down on Yahoo! all-night.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Well, that is -- so, it was -- I think something very flaky is going on. You may have seen I have been on CNBC and Bloomberg saying this, what I -- first of all, in the normal retail system as people like Macy's and Nordstrom's say they get their fall stuff in late August. They sell it, and then over Columbus Day weekend, which is like October 13 or 12 or something, they make a -- at the end of the weekend is when they do their sort of -- their forecasts and reorders for the fourth quarter.

And so -- and then we start getting calls normally in December, mid-December from their manufacturers who have been supplying them, who say we have not been -- well, they give us Overstocks that come in in January.

In our case we started hearing from the manufacturers and the distributors right after Columbus Day because the reorders were very light. The reorders from the mainstream brick and mortar guys were very light, and part of that was clothing. There was this unseasonably warm -- it was warm up throughout October. So the reorders to the manufacturers were light.

The manufacturers starting calling us a good month or six weeks earlier than they ever called in the past. And it was not just the manufacturers, actually distributors and there were a lot of people starting to be stuck with inventory much earlier than any time in our history when we were getting the calls.

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I think that what is going on is that we are trying to reflate our way out of this crisis, of course. They stopped reporting M3 a couple of years ago. But M3 is there is an economist something like was John Williams who runs Shadow Government Statistics who you can back into it. And he says, M3, our broadest measure of the money supply, is growing over 15%.

We are trying to reflate our way out of this housing crash. I think that a lot of -- in general, a lot of consumer spending has been driven by the housing boom, of course. And this is a 15-year pattern for us that we have -- we had the Y2K monetary expansion because allegedly people were worried about Y2K. That gave us the tech bubble. We ended with this crash. We reflated our way out of that. We had 9/11 crash. We reflated our way out of that. The housing boom under the housing bubble popping, now we are trying to reflate our way out of that.

I don't know if it is going to -- I'm really quite pessimistic about the state of the American economy. But we may pull it off again. I think it is kind of 50-50.

In general, not that I -- in general, that actually works for us, though, in two respects. One is, in normal times there is a professor in South Carolina who studies value shopping I guess because there's a lot of outlet stores and stuff there.

As I recall reading seven or eight years ago, the research shows that people who do discount shopping are low income people and wealthy people or affluent people. It is middle-class pays full retail. It is the affluent and the lower income people. You go to a Costco parking lot, it is Mercedes-Benz and junkers.

And so just if we go into recession, I think, though, that claim about the middle-class becomes less true. They become used to a certain standard of living. They start having to find ways to discount shop. That is one aspect.

Secondly, any time there's perturbations in the supply chain it actually is good for Overstock. In a perfectly steady-state world, there is not excess inventory. And theoretically in a perfectly steady-state world, everyone would know exactly what to produce for next month, and there would never be any excess. In very good times or -- well, uncertainty equals inventory in supply chain theory. The expression is you buffer or suffer. You buffer your uncertainty or you suffer the consequences.

So whenever there is a boom, manufacturers tend to overproduce. And whenever there is a sharp change, people will --. So when there is a boom or a bust, there will be overstock. It is kind of a lackluster economy that is most difficult for us.

So I think that if there is -- if you put all that together, I know the times -- well, we have always thought of it as the times that we do this is when there is either -- things are going very, very well in the economy or when there has been -- you know, when there was the tragedy of 9/11, and that just threw everything -- that screwed up the supply chain for everybody. And going back to Asia, the pipeline got stuffed with excess goods. That is when we get a lot of calls. It is when things are sort of lackluster that we don't get many calls.

Nathaniel Schindler - Merrill Lynch - Analyst

So, Patrick, if I can just paraphrase, you believe if this recession is a -- if the early stages -- if this is actually a recession -- at the early stages of recession, you are in a very good position because you will get both inventory and middle-class consumers who are trying to continue their lifestyle as their resources shrink. But if the economy -- if a recession lasts for a considerable amount of time, there will be less discretionary spending even at that end? And manufacturers will have better control on their inventory so you will get less inventory?

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Patrick Byrne - *Overstock.com - Chairman & CEO*

That is basically the idea. It is the moment of high beta, the moments of high beta where there will be the most excess inventory and people calling us. So if things went into a tailspin but a steady no beta tailspin, no beta slide, that would actually be hard for us.

Nathaniel Schindler - *Merrill Lynch - Analyst*

Okay. I'm just wondering going back into the pricing and how this is affecting pricing coming in, we saw some very aggressive pricing from Amazon. And I know it's pretty hard to go product by product, but is that becoming a threat or specifically to the third-party sellers on Amazon who are more likely to be Overstock merchants or people selling distressed inventory? Are they becoming more of a real threat at this point, or have you not noticed it?

Patrick Byrne - *Overstock.com - Chairman & CEO*

Well, certainly Amazon is doing very well with the third-party sellers. They have built a tremendous (technical difficulty)-- selection using third-party sellers. We hear from a lot of them. And the people, the experience of people who sell on both -- remember, we are now 80% third-party sellers. Now the experience of people who work with us and with Amazon is overwhelmingly positive, at least that is what they tell me in terms of the amount of sales they can get out of each SKU and as well a lot of other tangible and intangible factors. But Amazon has done a very good job of building out that supply chain with third-party sellers.

On the other hand, I don't think from my point of view the customer experience -- Amazon has a great customer experience, no question. But the customer experience with their third-party sellers is not so great. That is my take on it.

The difference between it is that we homogenize the consumer experience. They never know that they are getting from a third-party seller when they buy from us. Whereas with Amazon, I feel like the business model is somewhat different. You know, you're getting from a third-party seller, and the customer experience is not so great. I think that ours at the end of day is -- well, I think we have chosen the right path at least for us.

I have a note being passed to me from Jonathan. Do you want to add something, Jonathan? Hang on a second.

Jonathan Johnson - *Overstock.com - SVP, Corporate Affairs and Legal*

I think one thing that differentiates us from the third-party sellers on Amazon is they are trying to handle their latest and greatest products. And when they do that, it is very difficult for them to discount last year's product and have it selling right next to this year's product. And so many of those third-party sellers that are working to sell new products on Amazon are going to be selling the real deeply discounted products on our side.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Sorry, that is the basic model. If they are selling a lot on Amazon or eBay, we're starting to attract a lot of eBay dollars to our relationship with channel advisers. And we want them selling their -- using us to clear their overstocks at the steepest price.

So with Amazon and eBay, I think that what we end up with is again not the broadest assortment that those people put on other peoples' sites, which is part of the assortment they are trying to discounting most heavily. Thank you, Nathaniel.

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Nathaniel Schindler - *Merrill Lynch - Analyst*

I understand. Thanks.

Patrick Byrne - *Overstock.com - Chairman & CEO*

One more question? Dave has questions. Dave, why don't you go ahead if you have some questions.

David Chidester - *Overstock.com - SVP, Finance*

Okay. We had some other questions come in. One question was, what is Overstock's strategy for Canada?

Patrick Byrne - *Overstock.com - Chairman & CEO*

Great question. I mentioned somewhere and we got a bunch of letters about plans to go international. All of our international plans we're really into now projects which do not require much CapEx. We want to be information. We have learned it is the part of the chain that we can actually work in pretty well. But we want to substitute information for capital expenditure, and we clearly did that in the last year.

As far as going international, in all cases it will be ways that piggyback other people's infrastructure. So Canada is a different case than other international because it is right next to us and the same language and so forth. So that is probably the first one we're going to open up, and we're just evaluating partners now for the right partners to handle our -- to work with to -- we actually have a three-phased approach we're going to be taking to each country that we go into internationally. And they start with very low levels of commitment and capital expenditure. Canada may be actually a proof of concept. And I actually took one of our best players out of marketing who's been a very able person in marketing, Jake Bailey, to -- I broke him out and we put him under James Joyce and Jacob to develop our international business.

Okay. Any other questions that have come in?

David Chidester - *Overstock.com - SVP, Finance*

Another question was, do you feel Overstock will have to return to the Capital Markets for liquidity in 2008 or 2009?

I think I can answer that. We have talked about we're sitting with cash flow settled at 90 to \$100 million. We're running between 20 and \$30 million of inventory. In our CapEx requirements, we think we can generate enough operating cash flow to cover those. So no, I do not think for operations we have any -- we don't anticipate having to go to the Capital Markets. In fact, we have a buyback program out there in the case that we want to go to that.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Yes, it is our goal to stay free cash flow positive certainly for the year. I don't know if you even want to make a quarter by quarter, Dave, what do you think the chances are we are able to stay free cash flow positive in the first quarter forward?

David Chidester - *Overstock.com - SVP, Finance*

I would not make predictions on the quarters, but I think we can for the full year.

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Patrick Byrne - *Overstock.com - Chairman & CEO*

Yes, we still have -- I know that we're substituting more -- we've had some very good vendors, but we are cutting some additional costs out of the system. We made several million dollars more in cuts already, but most of that we're being -- we're replacing with more sort of mathematicians and people inside the Company.

But staying free cash flow positive, I know that you have one big lump this quarter is why I asked Dave. Don't you have a \$4 million CapEx this quarter?

David Chidester - *Overstock.com - SVP, Finance*

Well, I'm not sure exactly when that will happen, and that is why I don't want to make predictions on the quarters. So potentially yes, we could have some of it, a big piece of it hitting in the first quarter.

Patrick Byrne - *Overstock.com - Chairman & CEO*

So it would be difficult then maybe to stay free cash flow positive for the first quarter, but certainly for the year, which would mean that we would not have to be going back to the Capital Markets. Next, do you have any more?

David Chidester - *Overstock.com - SVP, Finance*

I have a question from Rob Wilson. He says, Patrick, I believe in December you went on TV and talked about your Company producing 5 to \$10 million of EBITDA for the quarter, and it does not look like that happened. What happened?

Patrick Byrne - *Overstock.com - Chairman & CEO*

Basically December came in -- things did not -- the Christmas season was not as sharp a spike as we had hoped as we were even -- things were looking great right up through Thanksgiving actually. And then as the weeks rolled on to the Christmas season, it was just a bit of a letdown. So what did we end up doing? \$3 million for the quarter in EBIT?

David Chidester - *Overstock.com - SVP, Finance*

Yes, just over \$2 million, and I think part of it was just margins. Probably the biggest thing was just margins came in lighter, sales and margins came in lighter than we anticipated in December, so.

Patrick Byrne - *Overstock.com - Chairman & CEO*

We did have a big November, and then just December got a little soft.

The other thing that has happened, though, is there was a -- let's talk a little bit about there is a note in our letter about our financial statements. And this we have made a change in accounting policy, and we really just decided this in the last couple of weeks. That hurt us in the fourth quarter to the tune of about \$5 million in sales and \$1 million or \$900,000 in gross profit and hence net income.

Do you want to talk about that at all, Dave?

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David Chidester - *Overstock.com - SVP, Finance*

Well, I think what I -- just so people understand, we have historically done things by ship date. And the reality is deferring -- whether you record revenue at ship date or delivery date, you are talking about delaying your sales an extra potentially three days.

But then those sales reverse into your next quarter. You make the same deferral at the end of the quarter. So really it does not change our business. The only time it really has an impact is the initial quarter that you set it up. When we fixed all the -- any cumulative issues from the past were all fixed in the fourth quarter.

So you do see this impact the day we set it up. Going forward, though, the two will really sort of offset each other, particularly in the fact that even though Q4 is a big sales quarter, at the end of the quarter, sales drop off that last week. And so it's really more reflective of sales in other quarters. So it's not like there's a big benefit of pushing three days of December sales into the first quarter.

So it really amazingly just sort of washes itself out. It is just it did have an impact this quarter as we set it up. And what going forward, we should not really see that type of an impact.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Let me explain real quickly, just when do you recognize a sale? Do you recognize it -- the convention has been and many -- has been when you ship the product, in the case of when you ship things by UPS and FedEx, title does not actually change until the consumer receives it. At the beginning of our Company's history, we looked at it, and the difference was immaterial or small enough, and of course, we don't really know exactly when people receive their products in general or we did not eight years ago. Plus, as far as we could tell in the industry, everybody recorded at ship date. Amazon, according to their financial statements, recorded at ship date.

So we chose the policy of recording at ship date. And one of the things that has happened in the last seven years is the information has gotten better where you can more feasibly look at when people receive their products. And more significant part of the industry has now migrated to recording at the date that things are received, even if it's an estimated date.

And so we have put together, Dave has put together, the systems that can make that estimate, so it will have the effect of shifting two or three days of revenue.

We're making this difference. Dave, do you want to say anything about, or Jonathan, about this issue? We have recorded this. We are putting a cumulative effect of this change into the fourth quarter of '07 through some chance --

David Chidester - *Overstock.com - SVP, Finance*

Yes, we are still working on that is the correct accounting for getting final approval. If it turns out that we do it differently, once again, we will change prior periods by small amounts --

Patrick Byrne - *Overstock.com - Chairman & CEO*

Prior 2007 periods, right?

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David Chidester - *Overstock.com - SVP, Finance*

Yes, 2007, 2000 -- it will go back, and we will fix all these little differences. Once again, it does not change anything regarding growth trends, earning trends. It is just the most correct accounting.

Due to the fact that we do take care of our customers until it gets delivered, if there's any problems with things getting lost or getting damaged in shipment, we sort of stand in for the customer and deal with the carrier on their behalf.

Patrick Byrne - *Overstock.com - Chairman & CEO*

But if this did go back and get spread across the second and third and fourth quarters, the difference is on the order of 0.5% of revenue or something?

David Chidester - *Overstock.com - SVP, Finance*

Yes, I mean it is a difference of \$9 million of revenue to 2007, and it would actually increase our revenue in 2007 and decrease revenue from previous years by that same amount.

So once again, on \$800 million years, we're talking about spreading \$9 million around. It is all very immaterial.

Patrick Byrne - *Overstock.com - Chairman & CEO*

Well, for the fourth quarter, we have made this -- we have made the assumption that it is going to be approved that we can make this change and put it into the fourth quarter. If that is, in fact -- and so that effect was \$5 million and \$1 million basically. So this is back to your answer, Rob, of what happened this quarter.

Well, \$1 million of the difference is, we have just made a decision in the last week that really cost us \$1 million of earning power in the fourth-quarter results. But if this gets -- if this does not get the auditors and the SEC approval and it goes back and has to be spread across a few quarters, then it will be -- you will actually see fourth quarter, when we do our 10-K, the fourth quarter will go up.

Anything else? Okay. I got it 10:00 exactly. Good questions. Thank you, folks. Those long-term shareholders who have stuck with us and seen us through tough times. I'm not ready to say turnaround is complete, but the fact that we are free cash flow positive, operating cash flow positive, EBITDA positive, strategically puts us in a very different light. We now have the cash flow to invest in new things that we were two years ago or three years ago we were thinking about the right things to do, but we have kind of earned two years in this terrible hiccup.

But we are back, and we have the wherewithal and the people now, and that is a big change too. We're not spread so thin at the management team level. We have -- really by any means, we have the people who can -- who have the skillsets to take on new projects like developing and international business. So I think it is going to start getting exciting again for us in '08.

Dave, Jonathan, anything you want to add?

Jonathan Johnson - *Overstock.com - SVP, Corporate Affairs and Legal*

No, we're just hard at work.

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Patrick Byrne - *Overstock.com - Chairman & CEO*

Okay. Thank you very much. We look forward to talking to you in a few months.

Operator

Thank you for your participation in today's conference. This concludes your presentation. You may now disconnect. Good day.

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