GRANT'S
INTEREST RATE OBSERVER®

Vol. 36, No.01d Two Wall Street, New York, New York 10005 • www.grantspub.com JANUARY 12, 2018

# Checking out

A hundred years ago, in the first Clinton administration, you called a travel agent to book a flight or reserve a hotel room. Now you visit the websites of Expedia, Inc. (EXPE) or Priceline Group, Inc. (PCLN; both on the Nasdaq) to close the same transactions. It's progress, to be sure, but progress, like time, marches on. To anticipate, progress is overtaking the business models of the Nos. 1 and 2 travel websites. We're bearish on Expedia.

Not so Mr. Market, who's penciling in double-digit revenue growth for each vendor through at least 2020. The essence of the bull case is that EXPE and PCLN have only begun to conquer their respective addressable markets. We bears reply that the two have already succeeded more than they're prepared to acknowledge. The good old days are behind them. Rugged competition—not evidently compatible with fancy price/earnings multiples—lies ahead.

Online travel agencies and metasearch sites constitute an industry called OTAs. The OTAs contract with hotels, car-rental agencies and airlines to bang the drum for business and earn a commission when someone buys a ticket. Search sites like Trivago.com and TripAdvisor.com scour multiple OTA websites. They compile deals and earn referral fees when consumers click on listings.

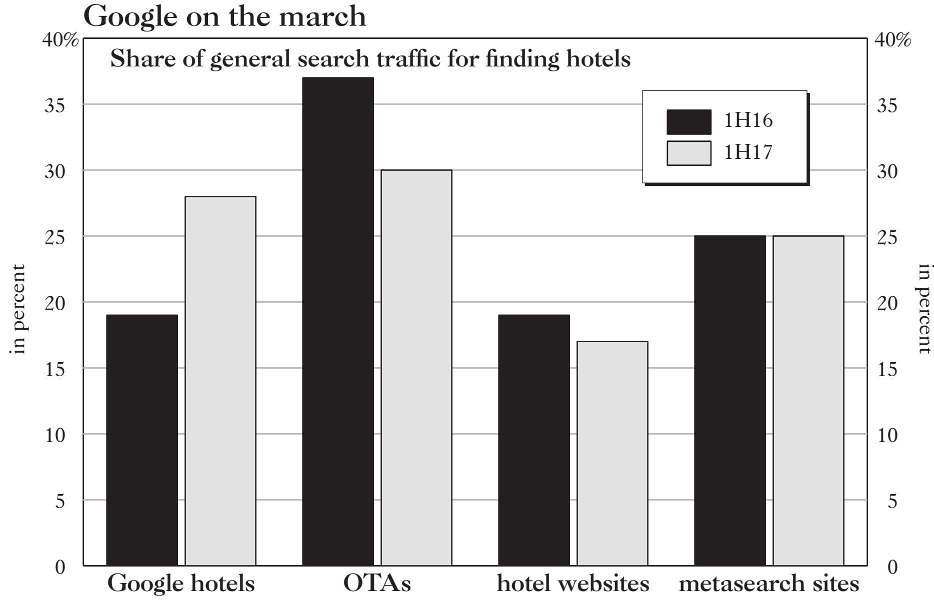
Expedia, with $9.8 billion in revenue in the 12 months ended Sept. 30, 2017, is the second-largest online travel agency after Priceline, which generated a $12.2 billion top line over the same span. Expedia is a global business with a home-market bias; the United States contributed 56% of trailing 12-months revenues. Expedia breaks out its business into four segments. Traditional OTAs, including sites like Expedia.com, Orbitz.com and Hotels.com, accounted for 75% of trailing 12-month revenues. Trivago.com, a publicly traded metasearch engine of which Expedia owns 59.7%, contributed 11% of trailing sales. HomeAway, a vacation-rental OTA (*Grant's*, Mar. 6, 2015), and Egencia, a corporate-travel agency, chipped in 9% and 5% of trailing sales.

At Expedia, net debt of $2.1 billion amounts to 1.3 times trailing earnings before interest, taxes, depreciation and amortization. In the third quarter, operating income covered interest expense by a healthy 13.9 times. The bears have no complaint about the balance sheet.

Liberty Expedia Holdings, Inc. owns 8% of Expedia's class-A shares (one vote per share) and 100% of Expedia's class-B shares (10 votes). This means two things for the stock: Investors get little say on corporate governance, and there is an elevated short interest (9.6% of the float) which is largely related to Liberty investors' hedging their Expedia exposure, rather than their betting against the company. The Street likes what it sees: Of the 34 analysts who cover Expedia, 26 say "buy," none say "sell." Shares trade at 42.8 times trailing adjusted earnings, or 49.5 times trailing GAAP earnings.

The bull case for online travel begins with the fact of an evident duopoly. Priceline and Expedia rule the roost, such independent metasearch

**Google on the march**




source: Phocuswright, Inc.

companies as TripAdvisor, Inc. notwithstanding. In addition to its own William Shatner–branded portal, Priceline owns Booking.com, Kayak.com, Agoda.com, RentalCars.com and Momondo.com.

"Cartel-like" the leaders may be, but they command exceptional bargaining power in one segment of the travel sector only: lodging. In the fragmented hotel business, OTAs earn commissions of 15% to 25%—book a $400 hotel room on Booking.com, and Priceline may garner as much as $100. Rental cars and airline tickets yield commissions of a few scant percent. In the third quarter, lodging accounted for 71% of Expedia's revenue.

Bulls believe the hoteliers need the OTAs as much as the OTAs need the hoteliers. Priceline and Expedia spent $7.3 billion on advertising in 2016, almost twice as much as the five largest hotel companies laid out together, according to a July 7, 2017 Morgan Stanley report. (The duo are, in fact, among the biggest global advertisers on Google.com.)

On Expedia's Oct. 26, 2017 earnings call, an analyst asked if the hoteliers could coax their customers to book directly. It would take more advertising dollars and more-generous loyalty programs, but it could be done—couldn't it? CEO Mark Okerstrom said he didn't think it was advisable. Better that the hotels stick to clean sheets and fast room service.

The bull story closes with the supposed low share of online bookings, a share expressed as a percent of total travel, with the emphasis on "total." The first full-fledged OTA, Travelocity.com (now a subsidiary of Expedia), debuted in 1996, two years after Amazon.com, Inc. In the ensuing 22 years, online travel has grown to no more than 35% of the total pie, according Phocuswright, Inc., the heavyweight in travel-related research.

Interested parties talk down even that low-ball estimate. Claimed Alan Pickerill, CFO of Expedia, at a Nov. 28, 2017 Credit Suisse conference: "We are a single-digit market share owner in the global travel market, which is, call it, $1.5 trillion."

"Our thought," Perry Gold, who rates Expedia a buy at MoffettNathanson Research, tells colleague Evan Lorenz, "is these OTAs have another five years of teens or possibly 20% per annum of revenue growth ahead of them if they grow, consolidate and offer better value and selection than offline players."

The bear case begins with common sense, on which we overlay a crucial fact about travel statistics. As to the first item, a question from deputy editor Lorenz: "When was the last time you, or someone you know, used a human travel agent or booked airfare over the phone? Where is this great Luddite horde in 2018?"

Concerning the second item, the online share of total travel booked is, indeed, about 35%, allows Douglas Quinby, senior vice president of research at Phocuswright. But he questions whether "total travel" is the relevant context for reckoning the market share of companies like Expedia. Corporate travel and the category called MICE—for "meetings, incentives, conventions, exhibitions"—constitute as much as 40% of that grand total. Critically, it's a segment that Expedia and Priceline largely leave to others. Make that necessary statistical adjustment, and the OTAs' share of the true addressable travel market leaps to 60%–65%.

Global GDP growth may be on the upswing, but Expedia's revenue growth is decelerating. In calendar 2017, gross bookings fell by 14% in the first quarter, 12% in the second quarter and 11% in the third quarter. And such growth as there was cost more to produce. Sales-and-marketing expenses jumped by 21% in the third quarter vs. total revenue growth of 15%. (Priceline has shown a similar deceleration in revenues and increase in marketing costs.)

At the start of 2016, such chains as Marriott, Hyatt and Hilton made a push to sweeten their customer-loyalty programs. In exchange for joining, and thus booking rooms directly, travelers can get discounted room rates and such perks as free Wi-Fi (which are typically available with direct booking only). "Hotels are all having some of the best quarters they've had in a while," says Gold. "Their loyalty sign-ups have gone through the roof."

Large chain hotels account for about 70% of the rooms in the United States, vs. around 30% in the rest of the world. This makes the threat of self-booking by loyalty-activated travelers a bigger problem for Expedia, which collects more than half of its revenue in the 50 states, than for Priceline, which rakes in just 16% of sales at home. Over the past two years, according to Phocuswright, the proportion of U.S. hotel guests enrolled in a loyalty program has surged to 63% from 47%.

And now comes Google. Type "hotels Central Park" into the search bar, and up pops the location and price of every hotel in Manhattan. The Excelsior on 45 West 81st Street offers rooms for $157, your phone informs you. Why would you log on to Hotels.com to pay $185? The Courtyard by Marriott at 410 East 92nd Street will cost you $139, whether or not you use an OTA. Google, however, knows a secret. You can "get a lower price plus free Wi-Fi with free enrollment" through Marriott's loyalty program. Sometimes, Google will book a room directly, cutting out the OTAs like the middlemen they are.

Data from Phocuswright show that Google's hotel offerings are capturing a rising share of search traffic: 28% of all searches in the first half of 2017, up from 19% in the first half of 2016. Online travel agencies are the biggest-share donors: Over the same six months, the traffic that OTAs captured declined to 30% from 37%. Things have come to such a pass that the online travel companies are shifting advertising budget to TV—yes, the very medium that saw a 3.1% year-over-year contraction in paying subscribers in the third quarter.

These threats are a much bigger problem for Expedia than Priceline given Expedia's American focus. In Europe, where Priceline generates 73% of revenues, big chains control only about one-third of room inventory. Small hotels can't afford to mimic a Marriott customer-rewards program. Nor can Google round up lots of small European operators as easily as it has enlisted a handful of American behemoths.

It's no surprise that fat hotel commission rates are attracting new competitors. Winding Tree, a crypto-coin startup, has concluded tie-ups with Lufthansa Group and the ATECH Foundation, an Aruba-based events company, to create a travel-focused blockchain that likewise banishes the middlemen. Points International Ltd. (PCOM on the Nasdaq), which manages loyalty programs on behalf of hotels and airlines, has created a program to rebate commission fees to travelers in the form of airline miles, a benefit to both consumers and airlines.

"We have six loyalty programs using our service now and offering their best customers a branded-hotel and car-booking experience," Christopher Barnard, president and co-founder of Points International, tells *Grant's*. "We have another five that we are in the process of launching over the next 120 days."

Another sign of the times is that lower commissions trimmed Expedia's third-quarter revenue by 3% per room per night. The large chains, emboldened by the growth in loyalty-program enrollments, will surely seek more concessions.

For our part, we are happy to welcome Expedia's management to the bear side of the market. On Aug. 30, 2017, Dara Khosrowshahi, CEO of Expedia since January 2005, announced his resignation to lead Uber Technologies, Inc., the ride-share problem child (see next story). In jumping ship, Khosrowshahi surrendered unvested options worth $184 million for the unsure future of Uber. Meanwhile, over the past 12 months, Expedia insiders sold 648,692 shares for $84.6 million in net proceeds. Not one officer, director or insider bought one share.

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