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EXPE - Expedia Inc at RBC Capital Markets Technology, Internet, Media & Telecom Conference

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Mark Okerstrom *Expedia, Inc. - EVP, CFO*

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Mark Mahaney *RBC Capital Markets - Analyst*

PRESENTATION

Mark Mahaney - *RBC Capital Markets - Analyst*

I'm Mark Mahaney, part of the Internet Research Team here at RBC. Andrew Bruckner works with me on Expedia and the online travel names. He's in our front row, too. I don't know much of the stuff; Andrew does. We're very pleased and honored to have Expedia's CFO, Mark Okerstrom, here. He was with us last year at our first annual Internet kickoff conference, and he's here again this year. And I know he's taking time out of his schedule, because he's shooting off from here to a focus right after it. So thanks for making the effort, Mark.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Happy to be here.

Mark Mahaney - *RBC Capital Markets - Analyst*

If you want to just give us a very 30-second overview of Expedia, and then I'll launch into questions. We'll leave plenty of time for Q&A, and we have a breakout afterwards. The mike is yours.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Thank you. Expedia, Inc., is the largest travel company in the world. We'll do just shy of $50 billion in travel in an industry that's $1.2 trillion. So we're the leader, and yet we've got under 5% share, which presents a pretty remarkable opportunity.

The industry is characterized by overall fundamental growth, which is usually GDP-plus. And then we've got this great tailwind behind us of a shift from travel moving offline to online, which is exactly where we play.

We address the market through a number of different brands. The brand that's probably the most recognizable is Expedia. Expedia is the only remaining full-service global OTA. There are regional players left, but we are the only global multi-product OTA left, and we're gaining share in every market in which we're operating.

We also operate Hotels.com, Hotwire, Trivago, which is the leading hotel-only metasearch player, who we are aggressively entering into the US with, as well as Egencia, the fifth-largest corporate travel business in the world. We have a majority position in eLong, which is the number-two OTA in China. So that's Expedia.

Mark Mahaney - *RBC Capital Markets - Analyst*

Super, Mark. Let's see. Mobile, the rise of multi-device access to the Internet, really just a bunch of more devices that people access the Internet -- that has to have helped your business. I think you've disclosed a material channel now, like 20% of your bookings come via mobile devices.

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Right.

Mark Mahaney - *RBC Capital Markets - Analyst*

I assume that's been a driver of growth, but any challenges? I just want to confirm that it has been an extra driver of growth, but any challenges along the way in terms of monetization?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Sure. It has been a nice tailwind for us, and there's a couple of reasons for that. One is we actually do think that in some respects, mobile bookings are incremental to the OTA platform. We see in the smartphone, for example, many of our bookings, 50% to 70% of them, are same-day or next-day bookings. That booking profile is dramatically different than the overall booking profile of desktop. A lot of that is walkup traffic -- you used to go directly to the hotel itself -- drive-by traffic. In the US, for example, now people are actually booking those on their smartphones on the road. So we think a big chunk of it is incremental.

We're pretty excited about the world of the app, world where you can get a download, get repeat usage, and not have to pay the Google tool along the way. And I think it's also been a tailwind for us because any time in this industry you've seen any significant technological advance, the OTAs who have invested heavily in technology are well positioned to not only take advantage of that and gain share from their competitors, but also in a position to potentially take some share from suppliers. So we've been very happy with what we've seen in mobile.

I would say the spot that's less bright so far for us has been in just the economics of mobile search. The efficiencies are not where we'd like them to be over the long term. We think they will normalize over time. But we think we can do a lot better on mobile search, and we think the channel will get better over time as well. But it's been less efficient.

Mark Mahaney - *RBC Capital Markets - Analyst*

Then is the ROI lower, then, for mobile search campaigns than for desktop search campaigns? Is that what you're saying?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes, yes.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

They are.

Mark Mahaney - *RBC Capital Markets - Analyst*

You've disclosed the number of hotels you have on your platform. I think you included the number of eLong hotels, but you broke it out. I think you have on your own platform 150,000 hotels globally or something like that?

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Closer to 200,000.

Mark Mahaney - *RBC Capital Markets - Analyst*

200,000? And there are what, 1 million hotel properties worldwide?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

A good estimate, yes.

Mark Mahaney - *RBC Capital Markets - Analyst*

And Expedia's been around for 17 years?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Good.

Mark Mahaney - *RBC Capital Markets - Analyst*

So what about the next -- get the rest of those hotels? How hard is it to get the rest of those hotels? Why aren't they on your network?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Getting more hotels on our platform hasn't been a huge priority for us until now. And the reason for that is that we had a lot of groundwork to do before we were in a position to really take advantage of new hotels. To be very effective at signing up new hotels and delivering business to them right away, you've got to have global online marketing platforms that can take a hotel and bid out keywords around the world. You've got to have a global multi-language website that can drop a Japanese customer on a page that's in Japanese for that Italian hotel. And you've got to have a hotel platform that is appealing to hoteliers. And for us, that includes agency hotel.

We have put those pieces together over the course of the last 3 or 4 years, and you've heard us talk about our technology replatforming effort. You've heard us talk about the Expedia Traveler Preference program. We've put these things in place so that now we are in a position where we can add up a new hotel in Italy, have it live on the site in a matter of days, and have it live in keyword campaigns in Google around the world in a few more days after that.

Mark Mahaney - *RBC Capital Markets - Analyst*

One of the biggest, most interesting elements, most important parts of the P&L, has been the sales and marketing line. And across online travel -- Priceline, Expedia, Orbitz -- it's been a source of deleverage. And I guess one of the questions that came up on the last earnings call was what's the scenario under which the OTAs, and Expedia in particular, would start seeing leverage in sales and marketing. Not when, not why, but -- yes, why? Why would you eventually see leverage?

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes. Well, I'll tell you what's causing it. There is a little bit of CPC inflation that is happening. In other words, a click is more expensive this year than it was last year. That generally happens when we see ADRs increasing as they are right now. And it also happens with more competitive intensity. So that's one.

Number two is, as we have improved the conversion rates of our website properties, that enables us to spend more in online marketing channels and allows us to really push growth in those channels. As a result, you can see some mix shift towards channels that actually cost you something away from channels like direct type-in, which are free. Now, you end up getting the virtuous cycle of getting the new customer in through an expensive channel and having the next time, type in direct, so it's all good business. But nonetheless, that can cause deleverage.

And then the last thing is just that international markets are generally less efficient because they're less mature than our core US market. And those markets are generally growing faster than our domestic market.

All of those things, with the exception of the CPC inflation, are things that are actually signs of strength. We are growing in international markets. We are able to acquire traffic at a higher rate from variable channels than we were before. The conditions on which sales and marketing starts to leverage are conditions when we are largely fully penetrated into this market. And again, we're under 5% of a $1.2 trillion industry, so we're a ways away from that.

Mark Mahaney - *RBC Capital Markets - Analyst*

Has your ROI on your paid search marketing spend been roughly consistent over the last couple of years? Because your conversion -- because with all the platform improvements, your conversion rates have risen so you can spend more on CPCs, so that's okay?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes. Generally, we take a view on what ROIs we are willing to accept. And when our conversion rates go up, we keep our ROIs essentially the same, and it just enables us to actually spend more and get more.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay. And you've also got plenty of other expenses on which you can get leverage. So those are okay if you get a little deleverage in sales and marketing.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Model.

Mark Mahaney - *RBC Capital Markets - Analyst*

And then international markets, less efficient. But over time, as you build up brand awareness and better understanding of those markets, what is that? Like a 3- to 5-year time from now?

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes, I think that's a good way to think about it. It depends on the local market conditions and whether or not there's a competitor who's a particularly strong incumbent. But if you take, for example, Australia, where we entered in the early to mid-2000s, it took us 4 to 5 years to build up a meaningful presence. And within that time, we were the number-one outbound OTA, and it took us another 2 years to become top three domestically.

Mark Mahaney - *RBC Capital Markets - Analyst*

What would you say are the most interesting international outbound markets over the next 3 to 5 years?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

China, definitely China. I think that the US continues to be a fantastic vendor of outbound traffic. And I think increasingly for us, Western Europe as well.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay. Do you want to just weight a comment on competitive shifts, market share in Western Europe, North America, and then whatever you want to -- everywhere else?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Well, I would say that the general theme that we're seeing in the market that we've seen this year is pretty consistent with that which we saw last year, which is the two global players continue to gain share, and gain share from mostly the smaller regional players. For us, that means that we're expanding more aggressively in Europe, particularly. For Priceline, they're coming into the US. And we think that's putting a fair bit of pressure on some of the regional players as we both expand into the opportunity ahead of us.

Mark Mahaney - *RBC Capital Markets - Analyst*

When does this market consolidate more? Because 10 years ago, we would have talked about two OTAS -- oh, no, 7 years ago -- really dominating the market, and we're talking about the same two OTAs really dominating the market even more now. So do you think we'll see consolidation or shakeout, or do you think we've already seen it? I'm missing it, or we've seen it?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Well, honestly, I think you're starting to see it. It's becoming visible. I think the deal we did with Travelocity is a testament to that. Travelocity was the first US online travel agency, and it was number one for a very long time. And now Travelocity is a marketing organization that uses the brand Expedia Platform. I think the Wotif acquisition that we announced and that we just recently received all of the regulatory clearances for and will close pretty soon here is another good example of consolidation. So I think it is happening.

Mark Mahaney: Hotels.com -- -oh, they were acquired. Kayak -- oh, yes, they were acquired. Trivago -- oh, yes, they were acquired. You're right. That's kind of a dumb question. I answered my own question, didn't I?

There is pressure in a few of your businesses. Hotwire, you just want to talk to that. I know it used to be material in terms of the EBITDA contribution. I don't think it is now, but just cover it briefly, please.

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes, so Hotwire is our discounted, we call opaque business. Hoteliers essentially give Hotwire largely distressed inventory. Hotwire is able to provide that to consumers at a very deep discount in exchange for those consumers not knowing the name of the hotel until the transaction is actually confirmed.

What's happened over the course of the last couple of years with Hotwire is that as the industry cycle has heated up and hotels have less distressed inventory, generally the availability of that inventory is lower and the discounts with which they're willing to offer Hotwire get worse. And in that respect, Hotwire is now, has always been, a bit of a countercyclical business. And we've liked that about them. But in good times, it can be a bit of a headwind.

That's been exacerbated by Priceline's introduction of Express Deals, which was a product that they introduced early last year, which is exactly the same as the Hotwire model, and it introduced some more competitive pressure. So you've got a less attractive macro environment for those businesses, and now they're basically sharing all of that pie. So it's a challenging environment for Hotwire. That said, it's a great brand. We are seeing some green shoots, I would call them, in some of the efforts they're making in mobile, some of the efforts they're making in some of the pricing intelligence and pricing automation initiatives they're doing. And I think you'll see probably a little bit higher mix of retail hotel with Hotwire going forward so that they can start to hedge some of this inventory risk they've got.

Mark Mahaney - *RBC Capital Markets - Analyst*

One last broad high-level question, which is this has essentially become a duopoly, more so -- strong word, but for most major markets, it's become --

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Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Not in China. There it's a separate duopoly.

Mark Mahaney - *RBC Capital Markets - Analyst*

Yes, which you both work with. So it really is kind of a global duopoly. It's become more so in the past, and the multiples have converged, and a couple of people figured that out. Jimmy figured that out a while ago, and I've had some great calls on it.

I'm just trying to think, what are the systemic risks to that? So one, it could be Google doing something, because both of you are very dependent on that. And second could be the hoteliers themselves -- I don't know, something changing there. But this industry outside of the US is so fragmented, that's probably not a risk. But address those two -- Google, you know, but I'll ask you this every year

Mark Okerstrom: I know.

Mark Mahaney: But Google as risk to the duopoly, and the -- whatever it was -- oh, the suppliers as risk.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes. Well, listen. Google is a big, dominant player, so I think we've always got our eye on what they're doing, and I think it's something we should all be mindful of. Now, we and Priceline are huge advertisers with Google and do a great business with them, and they've been a good partner of ours over the years.

All of the actions that they have taken over the years with respect to their travel product have been things that have generally been good for us. You know, changes they've made to their search algorithms to eliminate the low-quality free traffic that was available to the smaller players has

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helped lend strength to the bigger players. Their shift towards more of a metasearch product, for example, generally is a good thing for us. We do well in metasearch. So the moves that they're making have generally been good for us.

But we do watch them very closely. We do take a lot of pride and comfort in the fact that the business that we operate is a real business. There are real relationships with hoteliers, there are systems that hoteliers and airlines use to interface with our systems. The technology that we use is very, very travel-specific and very, very proprietary. And so what we do is actually difficult and difficult to replicate. And we do have some pretty significant experience in operating this business and some pretty big competitive barriers. So we watch Google, obviously. But so far, we feel good about the risk.

Listen, on the hotel front and whether or not hotels will find a way to disintermediate us somehow, you said it. Outside of the US, it's a very fragmented market. You mentioned probably 1 million properties. The majority of those globally will be independently owned, not part of big chains. And the chains are significant in the US, and they're growing outside of the US. But there really is fragmentation here. And because there's fragmentation, there is real value provided by intermediaries such as ourselves.

There is not an arbitrage opportunity here to the extent that hotels go direct. And they were to do something with another intermediary, such as a Google, I think they would find pretty quickly that the economics that they pay Google, if our experience is anything like their experience, are going to be as much, if not more, than the economics that they pay us.

Mark Mahaney - *RBC Capital Markets - Analyst*

I've got maybe one other -- it's not really systemic risk. But TripAdvisor is another funnel out there. And we've seen the collapsing of the marketing funnel, the OTAs going up through the acquisition of metasearch companies, and top-of-the-funnel companies trying to go down, Google with somewhat limited success, and TripAdvisor, maybe, maybe not. So instant booking and your thoughts on -- is this a P&T negotiation, if they do certain things and change things that you've signed up for? Or is there something structurally flawed with the instant booking offer to you now?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Well, I think it's more in the latter camp right now, which is that the way that instant book has been launched is a product that looks a lot like TripAdvisor wanting to keep the customer, the booking looking like it was made on TripAdvisor. And that's not a customer acquisition channel anymore.

And our business is built on the back of having strong online marketing channels where we can bid efficiently on -- have a customer come trial our amazing product, know our amazing product, experience it, and then come back again and again and again to us. And the TripAdvisor Instant Book product doesn't have those characteristics. And therefore, strategically and economically, it's just not something that we're right now interested in.

Mark Mahaney - *RBC Capital Markets - Analyst*

Two more questions, or three more questions. Overall macro travel conditions now? Scale 1 to 10, 10 being super, 1 being not so super?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

7 to 8. I think we've been pretty happy with the overall travel environment. I think there's obviously some pretty significant FX movements that we're seeing in Europe, and we called out a translation head risk. I think you heard Priceline call out some more significant, call it travel trends that we're moving around.

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But aside from that, the macro condition looks pretty good to us. And I would say generally, we're fortunate to be in a business that does pretty well in all macro circumstances. The peak of the peaks, we see things like we're seeing with Hotwire. And the trough of the troughs, we often see degradation in our unit economics, which is made up for by volume. But aside from those movements, we generally do pretty well.

Mark Mahaney - *RBC Capital Markets - Analyst*

The business model generally is attractive from a free cash flow perspective. You bought back stock a fair amount. You pay a dividend.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

We do, yes.

Mark Mahaney - *RBC Capital Markets - Analyst*

It's reasonable to expect that over the next 5 years, we'll see more of those?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes. I would just say that we are in a great business from a free cash flow perspective -- trailing 12 months, about $1 billion of free cash flow, pretty close with our trailing 12-month EBITDA. So it's a nice business. I think we've got a good track record of making this a nice balance between deploying that free cash flow against acquisitions. We do have a dividend. And making buybacks, we continue to be long-term believers in the stock, and over a long period of time, ultimately want to consistently reduce our share count.

QUESTIONS AND ANSWERS

Mark Mahaney - *RBC Capital Markets - Analyst*

Let me see. Does anybody want to ask a question? If not, I'll keep going. Please.

Unidentified Audience Member

(inaudible ? microphone inaccessible)

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes, so the question is between what we would call the merchant and agency model. We generally collect the money from the consumer upfront and then pay the hotel. Their predominant model under Booking.com was the customer pays the hotel at the time of stay, and then Booking.com will collect the commission.

Really, it was how the industry emerged. So we started in the US, where the merchant model was very prevalent, and that was the model that we launched when Expedia.com first started, essentially. It has, obviously, very attractive free cash flow characteristics. And so the entrepreneurs who created the company said, "If we're going to create an industry, why not make it that way?" Booking.com started in Europe, where the agency model was more prevalent, and they grew their business very successfully that way.

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We, a couple of years ago, launched a program called Expedia Traveler Preference, whereby we launched the agency model at scale, and now we have a significant amount of our properties -- at the last call, I mentioned about 50,000 of our properties on the Expedia Traveler Preference program, which is both merchant and agency. And it's a big part of our business now.

Unidentified Audience Member

(inaudible ? microphone inaccessible)

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

So the first question was it's a huge market, and it looks like a duopoly. Isn't there room for another? I think there probably is room for another, but it takes a lot of scale and a lot of work to build what we've built. We have scale advantages in terms of just the breadth of our relationships with our hotels, the habits that have formed with those hotels to manage our rates and inventory. So I think there is room for one more, but it's pretty difficult to build a global-scale OTA from scratch, and it's also difficult to build a global-scale OTA on the fly while you're operating a different business model.

With respect to the amount of leads that we get from TripAdvisor, it's not something that we've disclosed. The best way to try to get at a number is to take a look at the previous disclosures that we gave around how much we were spending on TripAdvisor and take that as a percentage of our total marketing spend. And just remember that we actually get a fair bit of our transactions from free traffic that doesn't actually show up in our sales and marketing line.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay, so one quick question, a last one about the comps for next year. So with Travelocity, which was a real nice boost to growth this year, and leaving aside Wotif for now, also there may have been negotiating down in some of the airline commissions?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Correct.

Mark Mahaney - *RBC Capital Markets - Analyst*

I think you've talked about that.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Yes, and Orbitz did, too. That's purely coincidental. That's an industry-wide thing.

Mark Mahaney: How should we think about growth next year? Is there a reason to think that the growth outlook next year could be more temperate than it is now for those two reasons?

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Well, we haven't guided to 2015.

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Mark Mahaney - *RBC Capital Markets - Analyst*

I meant 2016.

Mark Okerstrom - *Expedia, Inc. - EVP, CFO*

Okay. Well, then I'll give you a number. (Laughter) Listen, the only thing I'd say is that we did get a nice tailwind from Travelocity this year, but the underlying core business is strong. We continue to see nice trends at Hotels.com brand. Expedia's doing nicely. You can tell from our room-night growth that the underlying core business is performing pretty darn well.

The Travelocity business has given us the opportunity to lean in a little bit harder this year than we might otherwise have done. On the Q2 call, we mentioned leaning in on sales and marketing. We mentioned leaning in on beefing up our hotel supply sales force to really get out there and ramp up the number of new hotels we're signing up. And on this last call, we mentioned that we were putting another $15 million to $20 million on a year-on-year basis to work at eLong and Trivago.

So we think we're set up well for a good 2015, and the underlying fundamentals of the business look good.

Mark Mahaney - *RBC Capital Markets - Analyst*

Super. Thanks. Mark Okerstrom, CFO of Expedia. We'll have a breakout in the next room. Thank you very much.

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