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EXPE - Expedia Inc at Goldman Sachs Technology and Internet Conference

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PRESENTATION

Heath Terry - *Goldman Sachs - Analyst*

Great. So we'll go ahead and get started. My name is Heath Terry, I cover the Internet sector for Goldman Sachs. We're really happy to have with us today, Mark Okerstrom, the Chief Financial Officer from Expedia, but Mark for folks in the room that maybe know Expedia best as customers of the Expedia brand. Obviously, there's a lot more inside the Company. What's the right way to think about what you and Dara trying to build in Expedia?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, I think, it is essence, we are trying to build the world's largest and most diversified travel platform. The business that we've built through Expedia, Hotels.com, the recent acquisitions of Orbitz, Travelocity, [MrainMurdy Investments] and (inaudible) in Latin America, what we've done in Southeast Asia, our corporate travel business Egencia are all -- they put ourselves in this position where we're really a unique animal, where if you are a hotel or you are an airline or you're a car-rental company, on activities provider or increasingly alternative accommodations, homeowner or property manager, there is really only one global platform that you can go to and get distribution in 65 countries around the world. Offline travel agents, we power corporate travel agents, leisure travelers et cetera, all in one spot.

And from the consumer standpoint, again if you are a consumer, there's really only one place that you can go to on a global basis that has essentially all of the travel products you could possibly need. And that's ultimately the vision that we've been building towards for the last 10 years. We're in a spot right now where we still got some exciting growth stories on top of that. HomeAway is one, which we'll talk about that I'm sure in a bit. trivago is another, but the core travel platform idea is something that is now I think assembled and that we're excited about just executing on over the course of the next five years to come.

Heath Terry - *Goldman Sachs - Analyst*

So when you think about that core travel platform, there's a lot of brands outside of that now with the acquisitions besides Expedia and Hotels.com, which has always been the core, you now have Orbitz and Travelocity and Hotwire, and go on and on. What's the strategy behind that? Where, what value are you getting from having that umbrella of brands, particularly as things like organic search evolved in the way that they have been.

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, there are a couple of advantages. One is that over the course of the last 10 to 15 years, these brands that are part of the portfolio, in addition to Expedia and Hotels.com, which are the two big global brands, the Orbitz of the world, CheapTickets, Travelocity, ebookers, Hotwire [what if] These are brands that have collectively spent billions of dollars in brand building, for which they've received some real customer loyalty and we had observed over the years that despite the fact that consumers generally are shopping on 5 to 10 travel sites before they book. There were some real loyalty to a number of these brands and so part of the strategy was essentially, if you can buy these brands, you can put them on the brand Expedia platform which we have done, which is the leading multi-product and really only global multi-product platform exists.

You can get significant cost savings. And you can capture these customers that were brand loyal that maybe you would never get to, and so you get a loyal customer demand stream and you get it at a significant cost reduction. Similarly, there is an argument to the fact that customers want to have choice in the marketplace. And if we can provide them with that choice all under one corporate umbrella then it gives us the opportunity to capture essentially a bigger piece of pie.

Heath Terry - *Goldman Sachs - Analyst*

That make sense. Maybe a good place to start with some of this is the macro backdrop for travel. We've had an incredibly strong travel environment for the last five years and in that time, we've seen occupancy rates hit record high, ADRs hit record highs. What kind of an impact does that have on Expedia's business in terms of customer demand but also in terms of working with suppliers?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well generally, we do well in almost all travel environments. In the trough that we saw in 2008-2009, we saw heavy discounting into our channel that spurred more volume. We did just fine. At the peaks, where we have been close to the peaks, we generally as you've seen, we've done very well as well. At the peak of the peak, you certainly do encounter situations where the big suppliers that we deal with feel better about the business and the discussions around economics can become more, more heated. There can be situations where there is a less inventory available and that can impact some channels that are deeply discounted channels such as Hotwire and we've certainly seen that, but broadly speaking, a healthy travel environment for us, like we've been seeing -- seeing is a good place to operate.

Heath Terry - *Goldman Sachs - Analyst*

You mentioned how suppliers act in that sort of peak of the peak market. You've got a lot of suppliers [they've been] very vocal, we're cutting commissions, we're eliminating last room night availability, we're launching these direct booking programs. And yet, you guys are still showing very strong growth in your business, where does that or does that ever start to have an impact?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, I don't know if it does. We haven't seen an impact now. I think if there were a scenario where the big chains, we're all spending huge amounts of television marketing dollars, all training consumers that maybe they get a lower price, they book directly with them. I think [probably] long period of time, that would be a bad thing for us. I just don't think that's the right economic equilibrium for this industry. I mean, we are just a fundamentally different animal than these big chain hotels. If you look at the biggest of the chains, you are, call it 7,000 to 9,000 properties. We've got 350,000 properties.

And if you look at the big cities, a New York for example, maybe Hiltons got 37 hotels. We've got close to 1,000 hotels. We're just fundamentally a different animal and not only do we have better selection, but we've got rewards programs where you can stay at hotel X for 10 nights and stay in a completely different hotel, which is when you get your free night, which is what people generally want to do. The business travel is different from the leisure travel. So it's just a fundamentally different animal. And as a result, regardless of what the big partners decide to do on the marketing front or the discounting front, our consumers are looking for an incredible value. They value the selection, they value the prices that we've given, they value our loyalty programs, and they just keep coming back again and again and again. And we think that's going to continue forever.

Heath Terry - *Goldman Sachs - Analyst*

The other dynamic in this market the way we've seen has been the incredible growth in alternative accommodation, a lot of attention paid to both the public and private companies around that area. You guys have made a very big investment [now] with HomeAway. How is -- I guess what we're a little over a year into that, how is that working out for you and what is the strategy for HomeAway look like?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, we're very pleased with the progress at HomeAway. We did the acquisition. They had 1.2 million total properties. There was an ambitious goal to get larger portion of that online, where we're pleased to say that we now got 1.2 million properties that are online bookable and it's going to absolutely grow from here. We've launched the traveler fee that we launched in February 2016 in the US and in Europe in June. That has dramatically enhanced the monetization of the business, Online gross bookings which we've just started disclosing reached $6 billion in 2016, growing 46% year-over-year. So, the business has got a great amount of momentum. The consumer response has been solid, conversion has been -- is up year-on-year. Obviously, with our online property count, the suppliers seem to be adjusting to the new model. So all told, things are going really well. Now that said, there is still work to be done. We are ramping up selling and marketing. Now that we've got a variable monetization method, we can start spending more aggressively in online marketing channels. We have a lot of hiring, we want to do in the technology and product area that started through Q4, it's going to continue in Q1 and Q2. So there are investments going into the business, but progress is good. I should say though that we did set this target of $350 million of adjusted EBITDA that we feel very good about, it's not going to be a straight line there, and it's not going be a straight line there because of these investments we're making. And those investments will hit probably much harder in the first half of the year than they will in the second half of the year and the business is shaping up to be more seasonal than its historically ever been, it will start to look more like the core OTA business where you spend big on sales and marketing to generate bookings and revenue actually gets recognized in the back part of the year. So for 2017, HomeAway is going to have a very back-end loaded plan, it's very possible in the first half of the year, adjusted EBITDA could be negative. Given the factors I mentioned, as well as the fact that we still have the subscription revenue headwinds as we got rid of [tiers] which is going to continue in Q1 and Q2, but we feel very good about the progress. 2017 is going to be a solid year, and again, we feel very good about the $350 million target that we put out at the time of deal.

Heath Terry - *Goldman Sachs - Analyst*

And so how do you think, you touched a little bit on the change in the monetization model within HomeAway. How do you think about the way consumers on the platform as well as -- as your property managers, property owners that are listing on the platform have reacted to that booking fee and how much further can you take that?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well generally the reaction from consumers has been positive and we measure that in terms of conversion rates. There has not been a drop in conversion rates. When we first launched the fee, there was, we had anticipated a drop in conversion rates. There was a little bit less of a drop than we expected and since then its actually been increasing year-over-year. So far, it has not been a hindrance right now. We blend out about a 6% fee that caps out at just under $400. And I think, it's something that we're going to be testing with over time to see if there is an opportunity for better monetization, but so far we're happy with the progress there. On the supplier side, the initial reaction to the fee was that there was some concern voiced by -- I think in retrospect pretty [vocal] minority of the property managers and property owners, as we have developed the model, as we have been able to accelerate bookings growth, and as we've been able to drive more demand into these properties, that noise has largely subsided, I think people are adjusting to the new way of doing things. And overall, we'd say that now with the benefit of hindsight, it's been broadly positive across the board.

Heath Terry - *Goldman Sachs - Analyst*

That's great. The Google's push to move more or to dedicate more of their page space to their own properties, their own booking engine has obviously had an impact broadly across the space. How do you guys think about Google as a channel right now and what you potentially can do sort of working within that channel?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, our relationship with Google is very constructive. Our ability to compete in their [pay] channels has I would say never been stronger. We are broadly supportive of the product enhancements that they've made moving from the blue links to more of a metasearch product. Generally, we have benefited from these moves and generally, we do well in those channels. On the downside, they do continue to shrink the amount of free traffic that they're sending and that's obviously a headwind. It's been a headwind for a long time. I think it will be a headwind for a long time to come. And so, those two things balance out to say, it's a broadly constructive relationship. Obviously, we are mindful that they are a big player and occupy a dominant place in the search space. So they get an extra note of caution from us, but the relationship is solid in the channel. It's a good channel for us.

Heath Terry - *Goldman Sachs - Analyst*

How do you think about marketing costs generally where for somebody that sort of observes the space as a whole you're seeing, different philosophies in the market, you've got trivago who's spending close to 90% of their revenue on customer acquisition, trying to drive growth. TripAdvisor has [chalked] about having to spend substantially more and take margins down in order to try and reaccelerate growth. How -- you guys seem to be much more focused on maintaining your margins? How do you think about that trade off of growth versus the level of profitability you want in the business?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, generally speaking, I would say that the broad phenomenon of more people spending sales and marketing and intensity in sales and marketing channels, whether it'd be television advertising, or performance marketing channels is a fact of life in our business. I don't think it has changed significantly over the course of the last five years, it's always been the case. I expect, it's going to continue to be the case in for the next five years very possibly. For us, we generally view the world pretty simply, which is if we can develop great products that convert well, we're going to be able to afford to attract more customers to visit our websites and we do that through variable marketing channels, Google, TripAdvisor, trivago, et cetera. And if we can get those customers a great experience, they're going to come back to us directly through direct type in, or through our apps, et cetera. And we're really just operating under that formula. And what that means for us is that in many cases our variable marketing channels are growing faster than our direct traffic. That's usually a good thing. It means that we're able to afford more. And generally, our marketing efficiencies have been relatively constant in those variable channels over time, but because they have been growing faster its resulted in sales and marketing deleverage on our P&L and we're completely fine with that. We think that is evident of a business that is expanding and growing and is adding to the repeat customer base.

And from a profitability standpoint, we fund that through leverage and other cost categories, you know cost of sales, G&A obviously. Tech and content growing at a more reasonable rate and all of that has added up to a decent margin profile for us. We are less focused on EBITDA margin than we are EBITDA growth, and we got a track record of driven solid EBITDA, free cash flow and EPS growth over the past five years, and we're going to continue to strive for that over the next [five years].

Heath Terry - *Goldman Sachs - Analyst*

Great. So with trivago's IPO and Priceline is the latest acquisition in Europe, how are you thinking about Europe as a market, is there more that Expedia Group wants to do there, given those dynamics?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well I would set those dynamics aside for a moment. I don't think that the recent Priceline acquisition necessarily changes the dynamics for us. The dynamics are the same, which is we think Europe continues to be a huge opportunity for us. We have put ourselves in a position now where we have all of the ingredients necessary to be very competitive there. We have a standalone agency hotel product that [adds] market commission rates. We have become significantly better at online marketing than we ever have been before. We have great converting websites that are translated into every language. And I think if anything, you'll probably see us be an inch more aggressive in Europe in 2017 than we were in 2016 when we were pretty focused on integrating the number of acquisitions, and I think you'll see us be out an inch more aggressive actually everywhere outside of the US than we've been historically and I think that's going to be part of the overall operating formula for us for the next number of years.

Heath Terry - *Goldman Sachs - Analyst*

We talked about the investments that you've made in alternative accommodations and the strength that you're seeing at HomeAway. When you look at the competitive landscape there, how is Airbnb affecting online travel as a whole or just the travel market as a whole and Expedia specifically?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, we haven't seen an impact on our business from Airbnb aside from certain isolated circumstances where cities sellout like San Francisco during Dreamforce or New York during the Pope's visit in those situations, having that expansion capacity into alternative accomodations has generally resulted in us having better availability for to hotel inventory than we've had. Aside from [Nasco] we haven't seen a broad impact. What we do see is that Airbnb has created and continues to create much more awareness of alternative accommodations as a category and we think that creates a huge opportunity for us. Not only under the HomeAway banner, but also in our core OTA businesses Expedia and Hotels.com adding alternative accommodations either alternative accommodations that are acquired directly by our lodging team or alternative accommodations that the HomeAway team acquires and that we integrate on the sites. We think it's a big opportunity for us. We've recently integrated about 20,000 HomeAway properties on to Expedia.com. These are instantly bookable properties, a lot of them are in urban areas and we're going to be testing whether or not our consumers like that and resonate with us, but we are, we're pretty excited by the opportunity ahead.

Heath Terry - *Goldman Sachs - Analyst*

How important for HomeAway will be cross booking with the Expedia platforms?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, it's not important from the standpoint of hitting our $350 million adjusted EBITDA target. We do think it is important to the business over the long term. However, the demand profile on the Expedia and Hotels.com websites tends to be more urban. And to the extent that we can use that urban demand to create bookings into HomeAway properties that they might -- not otherwise do. We think that could be a big boost to HomeAway. I also think that HomeAway having access to some of the more traditional lodging products that our core lodging team signs up, again could also be an opportunity for them as well. I mean at the end of the day, consumers in many cases are I think in the future going to draw less of a hard-line between alternative accommodations and hotels. I think those lines are going to blur over time and I think to the extent that our core OTA brands, as well as HomeAway can offer a broader spectrum of properties that maybe step into the blurred zone. I think, it's going to give them big advantages over pure play players.

Heath Terry - *Goldman Sachs - Analyst*

As you've got further into owning some of the acquisitions, particularly some of the more mature brands like Orbitz and Travelocity. How are you thinking about what the margin profile for the business looks like in a steady state where you have optimized the costs of those companies being on your platforms and you've got to the $350 million from HomeAway, where do margins settle out or should they?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, it's hard to say. And again, we firmly believe that we are going to be in the position where this is a business that can leverage fixed costs. We have even said that 2017 is going to be a year where our fixed cost categories are growing much more slowly than they certainly they did in 2016. The question then is then how does that translate into adjusted EBITDA margins? And it's an answer we don't have, because as I said, we are spending direct sales and marketing to generate real profit and that real profit can come at worse efficiencies than our overall average and that can hurt EBITDA margins, but we're driving for better EBITDA dollar growth and free cash flow and adjusted EPS growth. So we're confident that again over a long period of time, we can leverage our fixed cost base. We are confident that we can grow adjusted EBITDA free cash flow and

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adjusted EPS very nicely over a long period of time, whether that comes from EBITDA margin expansion or contraction, we don't know. We don't actually spend a ton of time thinking about it.

Heath Terry - *Goldman Sachs - Analyst*

So that discussion of free cash flow ties back into one of the decisions you talked about recently in terms of migrating some of the infrastructure at Expedia on to AWS on to the public cloud platforms that are available. How does that impact the economics of the business, and particularly your cash flow and your balance sheet?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, it is cash flow accretive once you're in steady state. And the reason for this is when you operate your own data centers, you're generally buying capacity in lumps, you're paying for space, you're paying for power, and you're contractually committing to that. And you cannot buy that capacity as you need it. You're generally buying it two to three years in some cases, further out in advance. And then you're buying servers at $6,000 to $12,000 [a pop] and you are stacking them in ahead of demand. And when you make all of those investments, they happen in big lumps and for us you saw big lump in end of 2015 and into 2016 as we ramped up space for Orbitz.

They go in big lumps and when you make these expenditures, you have got to basically buy capacity a couple of years ahead. You've got to buy it also for the peak booking season. The intra-week, intra-day peak on that peak and then you got to add about 30% buffer. And then, you've got to contemplate a situation where there is a massive power failure in that unit and you've got to have failover capacity. So when you think about the amount of capacity you have to buy, which generally for us also is [up in] CapEx, it's significantly more than you're ever going to utilize and so it's economically inefficient.

With the cloud, what we can do is we can variabilize that cost and we can truly, we can commit to a base level of usage that we know we're going to head and then we can expand as we need it. And then, because of the way we're architecting the software, because of the way the cloud works, you could become largely hardware independent. So if there is a failure, you can switch over and have disaster recovery seamlessly and so you don't have to have that extra capacity.

So at steady state from a cash flow perspective, it's a no-brainer. It's also a no-brainer from the standpoint of having presence closer to consumers that gets rid of latency as well, but during the transition period, we've still got a whole bunch of data center capacity and we're building into the cloud. And so there are some double cost, you will see for us, you will see an offset to the cloud spend in reduced CapEx, it's not a complete offset, but there is an offset. And over time, what you'll see is that the CapEx that we're having to spend is going to go significantly down versus what it used to be in sort of the pre-cloud decision stage, because we're not having to buy new capacity, because we're not having to replace aging servers and from a free cash flow basis, it will be positive. It will always be an EBITDA headwind because we're putting expense up into the P&L that wasn't there. We still [risk than] $110 million in cloud expense in 2017. This is essentially direct spend with vendors AWS, Microsoft to some extent, Google and that's a number that's going to grow up and it is recurring, and it is real and in a couple of years, you're going to see that be accretive from a free cash flow standpoint, but it will take a lot for that to materialize.

Heath Terry - *Goldman Sachs - Analyst*

Got you. So we do have time for questions from the audience. If there are any just raise your hand, we'll get a microphone over.

QUESTIONS AND ANSWERS

Unidentified Audience Member

In terms of the (inaudible) . How do you think about, there's some bogies out there in terms of stock prices you need to hit over time. How do you think about the investment decisions, you're making relative to driving the stock towards their targets?

Mark Okerstrom - *Expedia, Inc. - CFO*

And you're talking about the equity incentive plans that certain senior management have ?

Unidentified Audience Member

Correct.

Mark Okerstrom - *Expedia, Inc. - CFO*

To be honest, we don't spend a lot of time thinking about those numbers, we spend a lot of time thinking about how do we continue to build this business for the long term and how do we deliver pretty nice growth rates, from bottom line perspective that compound year-over-year in and year out. And we think the stock price will take care of itself if we do that.

Heath Terry - *Goldman Sachs - Analyst*

Just one other area that we're diving into is Asia, you -- with the divestment of ELong, where do you think about or what is the right strategy for Expedia in Asia?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, we want to be everywhere. We are making great progress in Southeast Asia both Hotels.com as well as Brand Expedia in part with our AirAsia joint venture partnership, which we now own the majority of. We're making great traction in most parts of North Asia, South Korea, Japan is a very strong market for us. We're excited about the prospects in India. It seems like India may be at a stage now where some rationality could be returning to that market with the MakeMyTrip [Goibibo] combination and we'll be looking at India as a possible market where we could potentially be a little bit more aggressive in 2017 and 2018. And that leaves China and so far our strategy in China has been really twofold. One is that we have a number of brands in there including Hotels.com, including now Brand Expedia, Egencia, our corporate travel business, they are in China. Now they are predominantly providing outbound, or capturing the Chinese outbound market, because our inventory in Asia and in Europe and the North American cities where Chinese travelers want to go is unbeatable. And they are having great success there. We're also focused in Asia in terms of signing up or in China in terms of signing up properties where people from outside of China want to stay. So that's our one piece of the strategy, it's an outbound inbound strategy and it leaves sort of a gap around the domestic market, Chinese travelers to Chinese destinations and that's a gap we like to fill at some point, but we are realistic about our opportunities to do that and we're not being particularly aggressive there, but the second part of the strategy is we do have an Expedia affiliate network business that powers a number of online travel agencies in China, both with domestic inventory and with outbound inventory powers a number of offline travel agencies and airlines, et cetera. And that is keeping us from a volume perspective very relevant in China, both in terms of hotels outside of China where Chinese travelers want to stay. And then also in many cases in Chinese hotels themselves, but we do have a strategic gap in domestic China something that we are not particularly happy with, but it's the reality of things right now. And that has been a market that's been very difficult as we all know for Western Internet companies to do well in.

Heath Terry - *Goldman Sachs - Analyst*

Sure. And so, we do have time for maybe one more question. There is one from the audience.

Unidentified Audience Member

In terms of your cloud strategy, why is it important to have a third provider on Google for example, why not just stick to AWS and Azure?

Mark Okerstrom - *Expedia, Inc. - CFO*

Well, there's a few reasons. I mean, one is you would like to have some say in pricing. And to the extent that you have alternatives, you have more of a say generally. I think secondly from a risk perspective, ideally you have multiple vendors, so that if there is an issue with the one you have an alternative.

Heath Terry - *Goldman Sachs - Analyst*

Mark, thanks so much for taking the time to join us. We really appreciate it.

Mark Okerstrom - *Expedia, Inc. - CFO*

Great to be here. Thanks.
