

# Brokerage Research Digest

March 11, 2013

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<b>Expedia Inc.</b>	<b>(EXPE-NASDAQ)</b>	<b>\$65.17*</b>
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**Note:** This report contains substantially new material. Subsequent reports will have new or revised material highlighted.

**Reason for Report:** 4Q12 Earnings Update

**Prev. Ed.:** Nov 23, 2012; 3Q12 Earnings Update (brokers' material are as of Oct 31)

**Brokers' Recommendations:** Neutral: 61.1% (11 analysts); Positive: 38.9% (7); Negative: 0.0%

**Prev. Ed.:** 9; 8; 1

**Brokers' Target Price:** \$71.57 (↑ \$9.14 from last edition; 14 analysts)      Brokers' Avg. Expected Return: 9.8%

**\*Note:** Although dated Mar 11, 2013, share price and broker material are as of Feb 14, 2013.

**Note:** A flash update was done on Feb 5, 2013 (4Q12 Earnings Update)

**Note:** The tables below (Revenue, Margins, and Earnings per Share) contain material from fewer brokers than in the Valuation table. The extra figures in the Valuation table are taken from reports that did not have accompanying spreadsheet models.

## Portfolio Manager Executive Summary

Expedia Inc. (EXPE) provides travel products and services to leisure business and corporate travelers. It owns and operates a portfolio of brands, including Expedia.com, Hotels.com, Hotwire.com, Worldwide Travel Exchange and Interactive Affiliate Network, Classic Vacations, Expedia Corporate Travel, eLong, and TripAdvisor. The company offers a travel marketplace, travel products and services used by various leisure and corporate travelers and offline retail travel agents. The company has operations in the United States, Australia, Belgium, Canada, China, France, Germany, Italy, Japan, Mexico, the Netherlands, Spain, and the United Kingdom.

Key factors for evaluating an investment strategy for EXPE are as follows:

- A diversified revenue stream.
- International booking acceleration is strong
- Competition from its peers, such as Priceline (PCLN). Other risks include material structural changes in online travel agencies, competition from travel suppliers, and online agencies.

**Analysts' Opinions:** Of the 18 analysts in the Digest group covering the stock, 11 provided neutral ratings and 7 assigned positive ratings. Target prices range from a low of \$67.00 to a high of \$77.00 per share, with the average being \$71.57. The average expected return on the current share price is 9.8%.

**Neutral Stance (Neutral or equivalent outlook) – 11 analysts or 61.1%** –The analysts with a neutral outlook prefer to remain on the sidelines at the current stock price level. The analysts, though impressed with the company’s current performance, believe that economic and travel trends and growth in airfares would continue to cloud the near-term outlook for Expedia. Given the fact that Expedia faces increasingly difficult comps and airfare increases in the near term, the analysts feel that this business will be a headwind going forward. Management believes that the near-term impact from potential airline consolidation will be minimal for the company, but over the long term, these can affect the company’s performance.

**Positive Stance (Buy or equivalent outlook) – 6 analysts or 38.9%** – The analysts believe that Expedia will perform well going forward, based on its attractive competitive position among the online travel agencies, growth in the company’s hotel presence, and improving business fundamentals.

**Long-term Outlook:** The analysts are confident that management will continue to build Expedia as the travel planner of choice with strong fundamentals, including accelerating domestic booking growth; meaningful revenue contribution from Europe or from Advertising; and operating efficiencies from cost-cutting initiatives. However, rising airfares are likely to affect the company’s business in the near term while impact from potential airline consolidation is expected to be minimal. In the long run, however, consolidation could bring discipline to capacity and increase airfare, which could potentially hurt Expedia. The analysts expect total revenue to increase at a 3-year compound annual growth rate (CAGR) ('12–'15) of 11.3%, net income at a compound annual growth rate (CAGR) ('12–'15) of 17.1% and cash flow from operations at a CAGR ('12–'15) of 1.0%.

## Overview

Key factors for evaluating an investment strategy for EXPE are as follows:

Key Positive Arguments	Key Negative Arguments
<ul style="list-style-type: none"> <li>• Expedia’s execution in international markets has been strengthening.</li> <li>• Strong free cash flow position has enhanced the working capital of the company.</li> <li>• Expedia is well positioned to outperform most of its competitors and maintain its position as a leading travel planner.</li> <li>• According to the analysts, Expedia has materially improved its leverage through efficiency gains.</li> </ul>	<ul style="list-style-type: none"> <li>• Competition in the online travel industry is intensifying, with companies, such as Priceline and Travelocity, expanding their operations in Expedia’s markets.</li> <li>• Increase in airfares and weak macro conditions in Europe will likely have a direct impact on the company’s profitability.</li> </ul>

Based in Bellevue, Wash, **Expedia Inc.** (EXPE) provides travel products and services to leisure and corporate travelers. It owns and operates a portfolio of brands, including Expedia.com, Hotels.com, Hotwire.com, Worldwide Travel Exchange and Interactive Affiliate Network, Classic Vacations, Expedia Corporate Travel, eLong, and TripAdvisor. The company offers a travel marketplace used by various leisure and corporate travelers, and offline retail travel agents. EXPE offers travel products and services provided by various airlines, lodging properties, car rental companies, cruise lines, and destination service providers on a standalone and package basis. It also facilitates the booking of hotel rooms, airline seats, car rentals, and destination services from its travel suppliers, and serves as agent

in the transaction, passing reservations booked by its customers to the relevant travel provider. The company has operations in the United States, Australia, Belgium, Canada, China, France, Germany, Italy, Japan, Mexico, the Netherlands, Spain, and the United Kingdom. Check [www.expediainc.com](http://www.expediainc.com) for more details on the company.

**Note:** EXPE's fiscal year ends on Dec 31.

## Long-Term Growth

Expedia continues to execute even against the backdrop of unprecedented rise in oil prices and airline industry capacity reductions, delivering solid growth in bookings, revenues, and operating income before amortization (OIBA). With the advertising and media businesses and international sites delivering a significant portion of revenues, Expedia has meaningfully diversified its growth drivers and established a strong foundation for long-term growth in free cash flow and shareholder value.

According to the analysts, Expedia will be working to improve content, while extending its technology leadership. While competitive differentiation has narrowed down, management hopes to maintain an edge by moving away from transaction processing toward retail and merchandising. The company would continue to benefit from its industry-leading position, as its scale of operations is significantly large. Further, it also helps the company achieve industry-leading profitability.

The analysts with a bullish stance continue to believe that the long-term drivers include a favorable mix shift in revenues toward higher-margin segments, an attractive online travel advertising opportunity (through TripAdvisor) and plenty of room for international expansion. However, most of the analysts believe that once the Google-ITA merger gets approval, Expedia may face significant competition over the long term.

## Target Price/Valuation

Provided below is a summary of Valuation/Rating as compiled by Zacks Digest Research:

Rating Distribution	
Positive	38.9%↓
Neutral	61.1%↑
Negative	0.0%↓
Max Target Price	\$77.00↑
Min Target Price	\$67.00↑
Avg. Target Price	\$71.57↑
No. of Analysts with Target Price/Total	14/18

In general, the analysts believe risks to the target price include material structural changes in online travel agencies due to hotel margin pressures; increasing competition from travel suppliers, online agencies and potentially metasearch engines; and an uncertain macroeconomic environment.

## Recent Events

On **Feb 5, 2013**, EXPE announced its 4Q12 results. Highlights are as follows:

- Revenues were \$974.9 million, down 18.7% sequentially but up 23.8% year over year.
- Adjusted EPS from continuing operations was \$0.63 in 4Q12 versus \$0.58 in 4Q11
- GAAP EPS was \$0.05 in 4Q12 versus \$0.44 in 4Q11

On **Dec 24, 2012**, Expedia agreed to acquire a 61.6% equity stake in hotel search website Trivago for a total of €477 million or roughly \$632 million. The payment includes €434 million in cash and the remaining €43 million in Expedia stock. The acquisition is expected to close in the first half of 2013, subject to various regulatory and anti-trust approvals.

Trivago is a German search company that focuses on hotels. It compares more than 600,000 hotels across 140 booking sites in more than 30 countries and 23 languages. The company expects to exceed €100 million (or about \$132 million) in net revenues for 2012.

## Revenues

According to the press release, total revenue was \$974.9 million, down 18.7% sequentially, but up 23.8% year over year. However, fourth quarter revenues were well above the Street consensus of \$927 million due to accelerating room-night growth in all regions and an increase in air ticket sales.

### Bookings and Revenue Margin

Gross bookings were \$7.53 billion in the fourth quarter, down 16.9% sequentially but up 19.3% year over year. The revenue margin was 13.0%, down 28 bps sequentially but up 48 bps from a year ago indicating higher conversions on a year-over-year basis due to strength across segments, channels and geographies.

Conversions in both the domestic and international businesses followed the same trend. Corporate conversions were better than leisure and agency conversions better than merchant in the last quarter.

Provided below is a summary of revenue as compiled by Zacks Digest:

Total Revenue (\$ in million)	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Digest Average	\$787.1	\$1,199.0	\$974.9	\$963.4↑	\$3,448.9	\$4,030.3	\$4,663.0↑	\$5,213.6↑
Digest High	\$787.1	\$1,199.0	\$974.9	\$981.7↑	\$3,449.0	\$4,030.3	\$4,800.1↑	\$5,363.3↑
Digest Low	\$787.0	\$1,199.0	\$974.9	\$936.5↑	\$3,448.0	\$4,030.3	\$4,582.1↑	\$5,063.0↑
Y/Y Growth	6.7%	17.5%	23.9%	18.0%↑	13.7%	16.9%	15.7%↑	11.8%↑
Q/Q Growth	-22.9%	15.3%	-18.7%	-1.2%↑				

## Revenues by Channel

Around 75% of total revenue was generated through the merchant business (direct sales), another 22% came through the agency model (where Expedia operates as an agent of the supplier) and roughly 3% came from Advertising and Media. The three channels were down 9.8%, 21.5% and 5.7%, respectively from the Sep quarter of 2012. Growth from the year-ago quarter was 26.9%, 23.5% and 10.0%, respectively.

## Revenues by Product Line

Hotel and Air, the two main product lines grew 25% and 10% respectively from the year-ago quarter. The increase in Hotel revenues came from a 33% increase in room nights and a 3% decline in average daily rate ("ADR"). Revenue per night dropped 6%. In the fourth quarter, international room night growth of 49% was nearly three times the domestic room night growth of 19%.

Mix was clearly negative, as the growth in Asia (much lower ADRs and revenue per room night) remains much stronger than other regions and this will likely remain a negative impact on hotel margins, while driving up volumes. Expedia believes that the added scale of the lower-margin business would more than make up for the negative mix impact going forward.

Air was around 26% of revenues in the last quarter, a 10% increase from last year. The increase in ticket revenue was attributable to a 12% increase in ticket volumes and 2% increase in airfare. Revenue per ticket declined 2%.

## Revenues by Geography

Around 52% of Expedia's quarterly revenues were generated domestically, with the remaining 48% coming from international sources. The domestic business was down 21.9% sequentially, although it increased 12.6% from a year ago. The international business grew 24.1% sequentially and 22.2% from last year. The international business declined 14.9% on a sequential basis and was up 39.3% year over year.

## Revenues by Segment

Leisure customers remained the significantly larger contributors in the quarter, generating around 91% of revenues. Corporate customers (Egencia) accounted for the balance. The two segments grew -20.6% and 9.0%, respectively from the previous quarter and were up 19.9% and 88.9%, respectively from the year-ago quarter.

With TripAdvisor gone, Expedia is almost totally dependent on the Leisure segment (although it is beefing up the Egencia segment with acquisitions). Expedia continued to benefit from the acquisition of VIA Travel that closed in the second quarter of 2012. VIA's operations are mostly in Northern Europe, which has done much better than the South in recent times.

## Outlook

For 1Q13, management did not provide any revenue guidance.

Majority of the analysts remain encouraged by accelerating hotel growth worldwide at Brand Expedia and continued fast growth at Hotels.com and eLong, which is majority-owned by Expedia. They believe

that the VIA acquisition and market share gains will likely lead to higher bookings, increasing conversions, and operating leverage in 2013.

Further, the analysts contend that Expedia should continue to gain market share from traditional travel agents owing to its discounted prices, strong brand awareness and an array of travel websites. Despite economic uncertainty and slightly more challenging comparisons going forward, they expect domestic as well as international online travel spending to increase from the year-ago quarter.

Please refer to the Zacks Research Digest spreadsheet of EXPE for more details on revenue estimates.

## Margins

According to the press release, **pro forma gross margin** was 76.9%, down 277 bps sequentially but up 21 bps year over year. The sequential decline in volumes was the most important reason for the sequential contraction. Higher costs for credit card processing (due to merchant bookings growth), higher headcount and other costs related to VIA and increased headcount costs to support other operations across the world were partially offset by higher credit card rebates. As a result, gross profit dollars declined from \$955.4 million in the year-ago quarter to \$749.7 million in the fourth quarter.

**Operating expenses** of \$626.4 million were up 12.6% sequentially and 23.9% from last year. **Technology and content expense (T&C)** was \$134.3 million versus \$102.6 million in 4Q11. **Sales and marketing expense (S&M)** was \$393.6 million versus \$315.1 million in 4Q11 and **general and administrative expense (G&A)** was \$98.4 million versus \$87.8 million in 4Q11.

**Operating margin** was 12.7%, down from 19.9% in the previous quarter and up slightly from 12.5% a year ago. All except S&M expenses increased sequentially as a percentage of sales. However, both S&M and technology & content costs increased from last year.

Adjusted EBITDA as reported by the company was \$184.6 million, up 37% sequentially and 14% from the year-ago quarter.

On a pro forma basis, Expedia generated **net income** of \$88.9 million compared with \$80.6 million in 4Q11. **GAAP net income** was \$6.7 million compared with \$70.3 million in 4Q11.

Provided below is a summary of margins as compiled by Zacks Digest:

Margins	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Gross	76.8%	79.7%	77.0%	76.3%↑	78.0%	77.8%	78.8%↑	79.0%↑
Operating	15.6%	21.2%	14.3%	6.3%↓	17.0%	16.0%	15.4%↓	16.2%↓
Pre-tax	12.8%	19.3%	12.5%	4.6%↓	14.7%	14.0%	14.1%↓	15.1%↓
Net	10.2%	15.7%	9.1%	3.2%↓	11.1%	10.9%	10.4%↓	11.2%↓

## Outlook

For 1Q13, management did not provide any margin guidance.

The majority of the analysts expect expenses to increase in the first quarter. They believe that the company's continued investments in product enhancements and its technology projects will increase expenses.

Additionally they believe that the company's huge investments across those countries, where returns are either too low or have well entrenched competitors will also limit margin growth in 2013.

On the contrary, a few analysts believe that margins will improve from 2013 onward due to greater volumes.

Please refer to the Zacks Research Digest spreadsheet of EXPE for more details on margin estimates.

## Earnings per Share

According to the press release, adjusted earnings per share from continuing operations were \$0.63 in 4Q12 versus \$0.58 in 4Q11. The EPS was below the Street consensus of \$0.65 attributable to lower revenues and lower gross margins in the quarter.

GAAP EPS was \$0.05 in 4Q12 versus \$0.44 in 4Q11. The figure includes amortization of intangible assets, stock-based compensation expense, legal reserves and occupancy tax assessments, foreign currency (gain) loss on U.S. dollar cash balances held by eLong, unrealized (gain) loss on revenue hedges, non-controlling interests, and provision for income taxes.

Provided below is a summary of EPS as compiled by Zacks Digest Research:

EPS	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Zacks Consensus				\$0.11			\$3.00	\$3.65
Digest High	\$0.59	\$1.32	\$0.63	\$0.26↓	\$2.84	\$3.10	\$3.69↓	\$4.58↓
Digest Low	\$0.58	\$1.31	\$0.63	\$0.13↓	\$2.74	\$3.09	\$3.15↓	\$3.83↓
Digest Average	\$0.58	\$1.32	\$0.63	\$0.22↓	\$2.75	\$3.10	\$3.40↓	\$4.08↓
Y/Y Growth	-0.4%	2.4%	8.4%	-16.2%↓	8.3%	12.7%	9.7%↓	19.9%↓
Quarterly Growth	-54.9%	48.0%	-52.2%	-65.3%↓				

## Outlook

For 1Q13, management did not provide any EPS guidance.

A few analysts increased their FY13 EPS estimates to reflect the contribution of the VIA Travel acquisition and stronger-than-expected international growth, while others decreased their estimates to account for higher investments and expectations of higher tax rate.

Please refer to the Zacks Research Digest spreadsheet of EXPE for more details on EPS estimates.

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