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Get out of town

Say you've decided to vacation on the French Riviera. Your party numbers an even dozen, including children, in-laws, cousins and a pouty teenage au pair. You could book six or eight hotel rooms—or a single villa in Saint-Tropez. This being the 21st century, you can, and you do, book the villa. Now unfolding is a bearish story on the company that helped you secure it.

HomeAway (AWAY on the Nasdaq) is that company. It's in business to simplify the renting of vacation properties. Through a series of 22 acquisitions over the past 10 years, the company has built a network of 40 travel Web sites. There are sites for French rentals, Brazilian rentals, Australian rentals, American rentals, among others. Together they list more than a million properties.

As a public company since 2011, HomeAway has grown like a weed—by 94% in terms of revenues, 63% in terms of listings. And there's lots more growth where that came from, the argument goes, the market being large and fragmented and the rate of online penetration being low. To hear the bulls tell it, HomeAway will remain a principal beneficiary of the certain continuing migration of vacation listings online.

Certainty is implicit in the stock's valuation, which happens to be 229.2 times trailing earnings with a ratio of enterprise value (that is, market cap less $487.3 million in net cash) to sales of 5.6 times. On management's preferred metric of non-GAAP earnings per share, which excludes costs like stock-based compensation and the amortization of past acquisitions, AWAY trades at an only slightly less toppy 47.6 times trailing earnings. The Street—with 11 buys, eight holds and two sells—would seem to harbor the shadow of a doubt about the bullish investment case. We have robust doubts of our own.

Doubt No. 1 is that time and technology wait for no one. "In 2005," colleague Evan Lorenz observes, "HomeAway's competition took the form of newspaper classified advertisements. You can conjecture as much by the nature of the HomeAway product offering: As of Dec. 31, only 36% of the listings on company Web sites allowed booking online. For the rest, consumers had to call and/or e-mail the property owners directly."

By the end of 2016, if all goes according to management's plan, 100% of HomeAway's inventory will be bookable online. Then, again, online book-

HomeAway Inc.
(all figures in $ millions, unless otherwise indicated)

	2014	2013	2012	2011	2010
total listings (000s)	1,043	890	712	641	528
Revenue	$446.8	$346.5	$280.4	$230.2	$167.9
Operating expenses	406.7	312.7	250.6	207.5	154.1
Operating income	40.0	33.8	29.8	22.7	13.8
Net interest expense	(11.6)	1.2	0.9	0.4	0.2
Other	(7.2)	(6.0)	(2.6)	(4.4)	(3.3)
Profit before taxes	21.2	29.0	28.1	18.7	10.6
Taxes	7.3	11.7	13.2	12.5	(6.3)
Income after tax	14.0	17.3	15.0	6.2	16.9
Min. int., pref. stock dividend	(0.6)	0.4	0.0	(24.7)	(35.2)
Net income	13.4	17.7	15.0	(18.5)	(18.3)
Diluted shares (mns)	96.5	88.3	84.9	59.5	38.1
GAAP EPS	$0.14	$0.20	$0.18	($0.31)	($0.48)
Cash	813.2	319.4	269.8	184.0	77.5
Preferred equity	0.0	0.0	0.0	0.0	479.0
Minority interest	9.7	10.6	0.0	0.0	0.0
Debt	316.2	0.0	0.0	0.0	0.0
Net debt (cash)	(487.3)	(308.8)	(269.8)	(184.0)	401.5

sources: company reports, the Bloomberg

ing is state-of-the-art for newcomers in the vacation rental field—all of the one million-plus listings on Airbnb, for example, are bookable on the Web.

Doubt No. 2 concerns the sheer number of HomeAway Web sites. Would fewer not be better? Those 22 rapid-fire acquisitions did give the company an early lead in the vacation rental market, but the multiplicity of sites may prove a liability in competing against strong single brands.

HomeAway is a kind of for-profit bulletin board. As the cost is higher to list on all 40 sites than it is on a subset of the 40, not all of HomeAway's 1.043 million listings appear on every site. According to Alexa, an Amazon.com subsidiary that tracks Internet traffic, the two principal HomeAway sites—the eponym HomeAway.com and VRBO.com—command rankings 1,658 and 1,894, respectively, among all the world's Web sites. Not one of HomeAway's other sites even break into the top global 10,000. For comparison, Booking.com, TripAdvisor.com and Airbnb.com rank 119, 212, and 674, respectively.

"If you look at Expedia Inc., they have a host of different Web sites and brands that serve different parts of the travel experience or different audiences," Henry Harteveldt, the founder of Atmosphere Research Group, a research firm that focuses on the travel industry, tells Lorenz. "That's fine, but HomeAway is pretty much the same type of content and the same objective, which is helping travelers find available housing to rent while they are on some kind of a trip. I think consolidating the brands makes sense, and I don't think they can take this small step approach. I think they have to say, 'You know what, we are not getting the results we need. Let's figure out which brands deserved to be sunset.' They should get rid of at least a quarter and maybe half or more of their brands that simply aren't relevant anymore."

"When you are up against Airbnb, which is arguably a fortress brand, you can't have these dozens and dozens of itty bitty brands trying to nick away at it," Harteveldt goes on. "It won't work. We've seen this movie before and we know how it ends."

HomeAway's competitors, too, are booming. Airbnb, for example, claimed over 600,000 listings in June and more than 800,000 in September; it boasts over one million today. While HomeAway managed to post 17% year-over-year growth in listings between year-end 2013 and year-end 2014, that growth is flattered by acquisitions. Over the past three quarters, the number of listings is essentially unchanged.

Doubt No. 3 requires a short preface. The company offers property owners two types of listings: subscription and performance. A subscription listing is what it sounds like: You pay to list a property on one or more of HomeAway's sites. Costs can range to $500 a year or more. A performance listing is also what it sounds like: You pay for results. The cost is 10% of the rent income you receive. Performance listings, as a percent of the total, grew to 32% at the end of 2014 from 8% in 2012. Between the second and fourth quarters of 2014, subscription-based listings declined to 714,000 from 744,878.

The growth in performance-based listings, as well as the softness in subscription-based fees, prompts doubts about the strength of HomeAway's pricing power.

Bulls contend that HomeAway can keep raising subscription-based prices. They observe that revenue per subscription in the fourth quarter of 2014 was $477, up by 9.7% from the year earlier. Suppose, they muse, a typical property owner rakes in $15,000 to $20,000 per rental transaction. Compared to that substantial intake, $477 is peanuts. More exactly, it is 2.8% of the assumed revenue range. Maybe, they concede, HomeAway will not soon garner 10% on subscriptions (as certain competitors are said to do). Still, they insist, it could easily achieve 6%.

We dispute the premise. It's far from obvious that the typical property owner clears $15,000 to $20,000 in annual revenue through AWAY's array of Web sites. Reason with us: If realized vacation revenues were as high as that, why would a growing cohort of property owners choose to pay HomeAway a 10% fee for a performance-listing rather than the flat, $477 subscription fee?

Maybe what accounts for the shift to performance-based listings is that HomeAway's customers are listing their properties on Airbnb, Booking.com *and* HomeAway. "It is my understanding that there is a lot of overlap between the inventory available on HomeAway and Airbnb," Harteveldt says. "In other words, the homeowner takes their listing and puts it on HomeAway and Airbnb, potentially at the same time, to see which site will rent first."

Anyway, despite that 9.7% bump up in the average cost of a subscription-based listing, the average revenue per listing—subscription and performance together—fell by 5% year-over-year in the fourth quarter of 2014.

Last week, management served notice of anemic growth in listings in the year to come. "For [2015] we expect growth in subscription revenue to be driven predominantly by increases in revenue per listing," CFO Lynn Atchison told dialers-in on the company's earnings. "For performance revenue, we anticipate growth coming primarily from booking volume."

Still, the company continues to point toward a 15% year-over-year jump in 2015 revenue. How? By raising prices on the subscription side (perhaps by 10%, according to analysts) and by driving more traffic to performance-based customers. Of course, the driving won't come for free. Advertising outlays must rise—all else remaining the same—which means that profit margins must fall. The front office projects that adjusted EBITDA as a percentage of sales (management's preferred metric, which adds back stock-based compensation to earnings before interest, taxes, depreciation and amortization) will decline to 24.5% in 2015 from 26.7% in 2014. The adjusted EBITDA margin has, in fact, been falling since 2011, when it registered 29%.

"Which brings us to Doubt No. 4," Lorenz proceeds. "It concerns deferred revenue. As a business based mainly on subscriptions, HomeAway's deferred revenue should, over time, track with realized revenue growth. This should be the case even as more of AWAY's business shifts towards performance-based listings. Consumers tend to book vacation rentals several months in advance. HomeAway books these sales as 'deferred' until a consumer walks into the rental. Yet, deferred revenue only grew 12.1% year-over-year in the fourth quarter vs. a 21.5% growth in revenue (comprising 16.5% year-over-year organic growth and 5% growth from acquired businesses). In other words, to meet its 2015 revenue targets, HomeAway must raise prices."

Not that a dollar of incremental revenue automatically delivers an incremental dollar of profit. CFO Atchison gives voice to our Doubt No. 5. "I'll add, too," she said, "that the way we run the business, and this has been consistent forever, and certainly in the last four years when we've been public, that if we see over-performance during the year, you are going to see this management team put that money back into the business as opposed to taking that to the bottom line."

Which is to say that competition is torrid. To stand its ground, never mind to gain more, HomeAway must invest every available dollar in advertising. Even then, management isn't projecting an increase in the number of listings across the multitude of its Web sites.

Peformance-based listings are one thing at HomeAway. Performance-based compensation—we come to Doubt No. 6—is another. As to the latter, management appears generous to a fault. Compensation in shares of HomeAway reached $48.5 million in 2014. That compared to GAAP net income of $13.4 million and adjusted net income (management's preferred metric, which excludes stock-based comp) of $64.4 million. The optical appeal of share-based compensation is that it's non-cash. The substantive drawback is that it's dilutive. So it is that HomeAway's fully diluted share count has grown to 96.5 million in 2014 from 59.5 million in 2011.

On Feb. 26, HomeAway registered an additional 3,780,613 shares—worth $120.2 million as we go to press—to be given to employees. So long as the stock remains richly valued, management can afford this "non-cash" remuneration. Should the share price tumble, so would management's compensation. And if management tried to maintain its standard of living (including, perhaps, its own trips to the Riviera) by boosting its cash compensation, free-cash flow would accordingly suffer a knock.

"Could not HomeAway be someone's takeover target?" Lorenz reflects. "Anything's possible, though valuation would appear to stand in the way of most conceivable transactions. AWAY trades at 5.6 times EV to sales and 35.5 times EV to EBITDA. Expedia trades at 2.1 times EV to sales and 12.9 times EV to EBITDA. On Feb. 12, Expedia offered to purchase Orbitz Worldwide Inc. for 1.7 times EV to sales and 11.6 times EV to EBITDA. AWAY may be a takeout target, but perhaps not at the price a bull might be counting on."

With a $3 billion market cap and a short interest of 6%, HomeAway is by no means an illiquid or crowded short-sale candidate. Insiders are frequent and large sellers of the stock. Carl Shepherd, co-founder and chief strategy and development officer, sold 35,234 shares for $1.1 million the day before AWAY announced fourth-quarter earnings via a 10b5-1 sales program. We see things Shepherd's way.

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