



# Expedia, Inc. (EXPE)

Narwhal Capital  
Management

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## Opening Comments

Expedia, Inc (EXPE) is one of the world's leading online travel services companies. Its mission is to become the largest and most profitable seller of travel in the world, by helping everyone, everywhere, purchase everything in travel. Wow, what a concept! Sell everything to everyone everywhere! That is a big market!

Seriously, EXPE is a well known name in the online travel industry. Chances are if you have ever planned a trip using the Internet, you have used their services. Need a plane flight, a rental car, hotel room? They can have it all lined up for you in just a few short clicks of your mouse.

As of late, the stock has been really weak. Two straight quarters of earnings disappointments have sent the shares tumbling from their 52-week high of \$27.55/share to their 52-week low \$13.50/share (they are currently trading at \$14.62/share). That is an approximate 51% drop in the share price, while the S&P 500 is essentially flat over this same time frame.

Throughout the course of this report, we will analyze Expedia as a investment in hopes of reaching a conclusion; whether or not the recent weakness in the shares represents a buying opportunity or a protracted weakness in the stock price.

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## Company Background

Expedia, Inc. has a very interesting past. They were founded in 1995 as a division of Microsoft. In 1996, they were spun out from Microsoft as a separate entity. Then in 1999 they went public. USA Networks/Interactive Corporation, under the leadership of CEO Barry Diller, purchased a controlling interest in Expedia in 2001. In 2002, USA Networks purchased the remaining interest in EXPE. Throughout the next few years Interactive Corporation continued to acquire complimentary companies to build out the online services provided by Expedia.

In July of 2005, Expedia and Interactive Corporation split into two separately publicly traded companies. Barry Diller became CEO of Interactive Corporation and Chairman of Expedia, while Dara Khosrowshani, former CFO of Expedia, became the new CEO. The thinking behind this de-merger was that Wall Street was having a hard time deciphering the firm as a whole and that making them two separate entities would give greater clarity into the business models, growth characteristics, and earnings potential of both firms. The general understanding was that Interactive was the growth business, while Expedia was the cash cow.

Expedia has a very well-known collection of online businesses, namely Expedia.com, Hotels.com, Hotwire, and TripAdvisor. Their business strategy is to become the one-stop shop for everyone's travel needs. Given their 40% market share in the online travel world, they are well on their way to accomplishing this goal. Additionally, many of their sites, products, and services have been recognized as best in the industry.

However, competition in this industry is fierce and customer loyalty and switching cost are notoriously low. Shopping for the best deal online is very easy. Simply log onto Expedia, then pop over the Orbitz, then check out Travelocity...see who has the best prices and buy your tickets. Given these facts, Expedia has focused on being the largest and most complete service provider within the industry. With size comes the largest inventory of available rooms, bundled vacation packages, and a vast network of agents/suppliers. Nevertheless, this business is very competitive.

It appears to be this competitive landscape and Expedia's build out of its services which have led to back-to-back quarters of earnings disappointments. The pricing pressure applied by their peers, especially in the international arena, has led to lackluster top-line growth. Compounding this top-line problem was the expense increase associated with the firm's decisions to invest in long-term growth initiatives aimed at improving customer services and building longer term client relationship. It is management's opinion that both of these objectives are necessary to maintaining and enhancing their dominant market share position in the online travel services industry.

Despite the firm's relative youth (created in 1995, going public in 1999, and spinning out again in 2005), they seem to have gone through a lot. Through it all the firm remains very strong with no long-term debt on their balance sheet, excellent free cash flows (\$797 million FY '05 and \$440 million in Q1 '06), and solid earnings (\$228 million in FY '05 and \$23 million Q1 '06).

## Select Financial Data

EXPE had \$2.119 billion in sales and \$228 million in net income for the fiscal year ending 12/31/2005. This represented a 14.9% jump in annual revenue and a 39.8% jump in annual profits as compared to the previous year's data.

As important as these revenue and profit figures are, we think cash flows give a better picture of the overall financial health of a company. In fiscal year 2005, EXPE generated \$849 million in cash flow from operations and \$797 million in owner's earnings (CFFO-CAPEX). These figures represented a respective 5.8% and a 6.4% increase relative to fiscal year 2004.

Furthermore, balance sheet strength is an important issue. At the end of the 2005 fiscal year, EXPE had a debt to equity ratio of 0.00 versus the industry average of 0.08. EXPE had less debt relative to equity capital as compared to their peers. However, debt levels appear to be low throughout the industry.

Data is taken from a variety of sources and in thousands were appropriate

	2005	2004
<b>Total Revenue</b>	\$2.119	\$1.843
<b>Net Income</b>	\$228.7	\$163.4
<b>EPS</b>	\$0.65	\$0.48
<b>Gross Margins</b>	77.7%	78.7%
<b>Operating Margins</b>	18.7%	13.0%
<b>Net Margins</b>	10.7%	8.89%
<b>CFFO</b>	\$849.8	\$802.8
<b>CAPX</b>	\$52.3	\$53.4
<b>Owners Earnings</b>	\$797.5	749.4
<b>OE/Share</b>	\$2.28	\$2.20
<b>Debt to Total Capital</b>	0.00%	0.00%
<b>Times Interest Earned</b>	n/a	n/a

# Valuation

When analyzing a company's valuation, we use a variety of metrics to get a well-rounded valuation picture. Traditional historical metrics are used, specifically price to earnings, price to book, price to sales. Additionally, we use proprietary valuation metrics that are principally based on the cash flows generated by the company. Depending on the type of company (mature, growing, start-up, acquisition based), we use different derivatives of our cash flow valuation model.

## Traditional Valuation Models

**Price-to-Earnings**...EXPE trades at 20.9 times its trailing twelve months earnings and 24.7 times its expected fiscal 2006 year end earnings (12/31/3006). The industry average P/E is 39.6.

**Price-to-Sales**...Currently, EXPE trades at 2.23 times sales. The industry average is 5.88.

**Price to Book**...Currently, EXPE trades at 0.8 times book value. The industry average is 6.16.

## Proprietary Valuation Models

**Risk premium and interest rate owner's earnings model**...Looking at EXPE's 2005 FY owners earnings, current interest rate levels, and historical equity risk premiums, we value EXPE's stock at \$34.03/share.

**Growth company owner's earnings model**...Looking at the growth rate of owner's earnings, we value this company at \$8.20/share.

**Acquisition based free cash flow model**...Looking at history of acquisitions, their free cash flow generation ability, their return off of free cash flow generation for shareholders, we value the firm's shares at \$9.12/share.

One of our main beliefs is that a company's owner's earnings and free cash flow generation capabilities are a leading indicator of future earnings movements. Furthermore, "Mr. Market" generally rewards a company that is growing its earnings with a higher than industry average P/E. Combining these two thoughts, we believe that our proprietary cash flow models can be used as a tool for potential future P/E expansion or contraction.

Looking at EXPE's earnings and cash flows indicates this firm is a low growth, cash cow. This is nice in many ways, but the market will not allow this firm to trade at normal multiples until they can see some continuity between the firm's rhetoric and their results. The firm has shown little growth, but it's claiming to be reinvesting its cash flows for growth.

## Price Target Discussion

When deciding on price targets for an investment, we consider the following:

- What is the fair value for the company assuming no non-systematic influences?
  
- Are we willing to buy this company at fair value or do we need a discount to fair value before we would consider purchasing these shares?
  
- What price level would potentially compel us to overweight, or buy more than an average position, of the stock?
  
- At what price would we sell the shares or at least trim our holdings in the stock?

**Fair Value...**For a stock like Expedia it is difficult to come up with a *tabula rasa* fair value. The firm is a cash cow, but instead of paying a dividend, it reinvests cash flows in the business for growth. With a stated goal of being the biggest and most profitable online travel service in the industry, it is clear the firm won't pay a dividend for the foreseeable future. If the firm were to trade at the same P/E ratio as their peers, you could look at their expected FY 2006 earnings, industry average P/E and derive a fair value is \$21.78/share. Doing the same with the industry average Price to Sales ratio indicates the fair value is \$22.26/share. Using the industry average price to book indicates a fair value of \$91.12/share for EXPE. As previously mentioned, our proprietary models indicate a fair value of about \$30.42/share on our basic owner's earnings model, while our growth model indicates a fair value of \$8.20/share, and our acquisition based free cash model indicates a fair value of approximately \$9.12 per share of Expedia, Inc.

**Buy Price...**At what price point does it become compelling to want to be an owner of Expedia, Inc? The firm is arguably the most financial sound company in the industry with the strongest and most consistent cash flows. They have taken on a low-debt, slower growth mentality than their peers, which is causing some short-term hiccups. Assuming the firm can show some steady growth going forward, the stock is a buy at current levels. Given their size and strength, we think it is warranted for the firm to trade at the market multiple for earnings. So, buying below \$20 for an initial purchase seems reasonable.

**Overweight Price...**The firm is currently going through some major turmoil. They have disappointed the market two quarters in a row on earnings and the market has punished the stock allowing it to languish below book value and below market multiples on most every traditional valuation metric. However if the firm cannot show consistent growth, the market will continually shun the stock until they begin to pay a dividend. We would not overweight the stock until growth occurs, a dividend is paid, or the stock falls below \$10/share.

**Sell/Trim Price...**If shares of EXPE were to trade above our fair value derived via market P/E ratios (\$21.78), we would consider trimming our positions. Furthermore, if the stock were to appreciate above the \$30 price derived from our basic owner's earnings model, we would consider selling EXPE.

## Bullish Argument

Someone who is bullish on Expedia, Inc. most likely believes the following:

- The firm's balance sheet strength provides a major advantage for their long-term growth strategy.
- The firm's strong cash flows will give it ample firepower to generate real top and bottom line growth.
- The opportunity for international growth, in tandem with the firm's size and strength, opens growth related doors for EXPE shares.
- The boom in the global economy gives many more consumers discretionary income and, therefore, the means and the need for travel related services.
- The falling dollar and the firm's international expansion efforts should pave the way to improving financial statements.
- The firm's recent spin out from Interactive Corporation should focus management solely on the online travel industry and boost results.
- Given the firm's dominant market share, they deserve to trade at premium levels on historical valuation measures. They currently trade at discounts to market multiples on Price to Earnings, Price to Sales, and Price to Book.

## Bearish Argument

Someone who is bearish on Expedia, Inc. most likely believes the following:

- The firm's management is not competent enough to navigate the ever evolving online travel industry.
- The industry is too competitive and margins will erode over time as customers and suppliers have leverage over firms like EXPE.
- Not only is the industry ultra-competitive in good times, but if geo-political issues continue to escalate, oil prices remain in an upward trend, and/or the global economy slows, demand for the services of online travel agents will dry up.
- They don't pay a dividend.
- The big investments they are making now for the future are too costly and will drain the company of their much discussed financial strength, just as their competitors are poised to steal market share in the much desired international markets.

## Conclusion

Expedia, Inc. is a unique firm. In an industry known for its Internet presence, high-technology, and whiz-bang, EXPE functions with an old school business model; low debt and high cash flow. We must say that we love companies with very little debt and large amounts of free cash flow. However, we need to see some growth. The firm bangs the table about its technology investments that will pave the way for long-term customer loyalty and long-term growth...quite simply, we need to see results.

At \$14.62 a share, an investment in the firm appears to be a fairly attractive risk/reward play. We would caution our clients, and potential investors in the stock, not to get overly enthusiastic about the stock at this time. The market will certainly take a wait and see attitude concerning the shares, given their recent quarterly disappointments. But if the firm can show "The Street" that their long-term investments in technology are paying off, the shares could rally to \$20 a share or higher. That would be a 36% return from these levels.

Patience is the key to an investment like this. We cannot see any quick turnaround in the share price. Therefore, "get rich quick investors", this one is not for you.

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At the time of publication, Matt Burton did not own any shares in any of the companies mentioned within this report, while Mac Plumart did own EXPE shares.. However, they own mutual fund shares which may hold shares of the stocks mentioned in this report.

Finally, we must disclose that PAST PERFORMANCE DOES NOT GUARNATEE FUTURE RESULTS.