The Online Travel Agency (OTA) industry will experience slower growth in the future. Bookings through the travel portals have been flat in the airline and car rental space for the last few years. The primary driver of revenue has been hotel rooms, but high occupancy rates raise concerns that the industry has peaked. Profitability is driven by the hotel bookings, and margin might become compressed as the hotels gain better bargaining positions. The companies in the industry, known as online travel agencies, have mixed valuations suggesting declining growth expectations are starting to be priced in.

**Industry Risks**

- Growth for travel websites has been driven by bookings moving from offline to online. The shift is largely complete, with internet penetrations high in the richest economies, and 53% of all travel being booked online.¹
- Global crises are weighing on the travel market, and present multi-year risks. Europe is a major travel market, and has been hit by terrorism and the flood of migrants. The structural economic problems in Europe have not been resolved. Latin America is a growing market, but the Zika virus is reducing travel. Travel is sensitive to geopolitical and macroeconomic risks.
- Price parity agreements that prevent travel providers, such as hotels, from offering lower rates on their own websites then the travel portals may be removed increasing competition and weighing on profits.²
- Travel service providers such as hoteliers and airlines are encouraging customers to book directly on their platforms to avoid paying fees and commissions to the OTAs.³
- A stronger dollar could bring down revenues of the industry on a currency-adjusted basis since a substantial portion of revenues and a great deal of revenue growth are generated overseas.

**Positive Industry Trends**

- Significant momentum in the growing Chinese travel market could drive revenues even higher.
- Increased access to internet and growing disposable income among the middle class in emerging markets may drive bookings for OTAs.
- A stronger dollar could spur increased travel overseas and boost domestic growth.

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**Investment Thesis**

**Key Industry Statistics (Cap-Weighted)**

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E</td>
<td>28.9</td>
</tr>
<tr>
<td>P/S</td>
<td>7.19</td>
</tr>
<tr>
<td>ROE</td>
<td>24.65%</td>
</tr>
<tr>
<td>Est 3-5 Yr EPS Growth</td>
<td>21.16%</td>
</tr>
<tr>
<td>Historic 3-yr EPS Growth</td>
<td>23.8%</td>
</tr>
<tr>
<td>Hist 3-Yr Sales Growth</td>
<td>23.1%</td>
</tr>
<tr>
<td>Beta</td>
<td>1.43</td>
</tr>
</tbody>
</table>

**Top Firms by Market Cap**

- Priceline: 66,766M
- Expedia: 16,162M
- CTrip: 13,571M
- TripAdvisor: 9,374M

**Custom Portfolio Weights**

- Priceline: 63.07%
- Expedia: 15.30%
- CTrip: 12.78%
- TripAdvisor: 8.85%

**OTA Industry Key Stats**

- Source: Factset
- P/E: 28.9
- ROE: 24.7
- P/S: 7.2

**Industry Description**

The Online Travel Agency industry is composed of websites that allow consumers to search for and purchase airline tickets, car rentals, or hotel accommodations from providers of those services. The companies only serve as an intermediary in the transaction. The companies serve as a way for customers to shop around, customize packages, and find special rates. Advertising to website visitors forms a small part of revenues. Competition between companies tends to be based on advertising expense, but concentration is very high with a few firms generating the bulk of revenues.

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¹ Internet penetration
² Price parity agreements
³ Direct bookings
EXECUTIVE SUMMARY

Growth in the Online Travel Agency industry is likely to be below the expectations set by the last few years. The conversion from offline to online booking is largely complete, and industry growth depends on slower organic growth of the whole travel industry as opposed to a shift within it. As travel service providers react to the slowdown in growth the OTAs could face declining rates on transactions hurting profitability. Providers of travel services seek to cut out the intermediaries. A strengthening dollar will weigh on international revenues.

Hotel room bookings are a significant driver of revenue for much of the industry. The chains that dominate the US market make it more difficult for OTAs to compete against direct bookings by consumers on the website of the hotel and airline companies. Europe presents a better opportunity due to a fragmented hotel market. However, the recent Paris and Brussels terror attacks may put a damper on the travel industry. The Brussels attacks occurred too recently to be properly assessed for damage. OTAs have not come out to talk about specific harm from the Paris attacks but some travel companies have released information. Air France-KLM lost over €50 million. Hotel booking cancellations cost the industry over $530 thousand in just the first 72 hours after the attacks. It is upon these substantial, but essentially unforeseeable risks that we base our sell recommendation.

Industry Description

The Online Travel Agency industry is made up of only a few firms of any size. There are frequently new entrants, but there is intense consolidation in the industry. The major companies own many different branded websites, some of which offer different services such as Booking.com owned by Priceline that books accommodations primarily in hotels but also in apartments like Airbnb, though Booking.com is solely focused on listings from commercial businesses. OpenTable is also owned by Priceline and allows making reservations through the website or the mobile application.

Most of the websites function like metasearch engines that pull prices and offerings from their network, and in some cases the websites of the providers themselves. The term metasearch is used since each provider’s website is a search engine that shows listings from only that company across times locations, or services. Most Users of the websites have a large variety of options. Offerings tend to be replicated from site-to-site, barring some restriction like geography such as China’s CTrip. There is some differentiation among the firms in terms of features or services, like Priceline’s Name Your Price®. Each site receives a commission every time a booking is made on the site. Online advertising space specific to travel is also sold. This creates two types of customers, travel consumers and travel providers.

Revenue Streams

Revenue falls into one of three buckets.

The first is agency revenues where the website is simply an intermediary that connects a traveler with a provider of travel services, but the website is not the merchant of record. The costs of the transaction are not borne by the website owner. There would be no cost of revenue, cost of goods sold, associated with these transactions.

The second is merchant revenues where the website is the merchant of record, and costs associated with the transaction are borne by the website owner. These costs include credit card processing fees, costs associated with securing a package or deal, and any other fees that might be associated with the transaction. Priceline’s Name Your Price® feature falls in this category.

The third bucket is the advertising bucket, which is the smallest source of revenues. Advertising also does not have associated costs since unlike Google the ads are displayed on company-owned websites. Revenue growth in advertising has been strong year-over-year as the providers compete amongst each other to win market share. The industry is one of intermediaries that is insulated from and tends to benefit from the intense competition among travel service providers.

Table: Revenue Sources in 2015 ($Millions)

<table>
<thead>
<tr>
<th>Company</th>
<th>Agency</th>
<th>Merchant</th>
<th>Advertising</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expedia</td>
<td>1,882</td>
<td>4,204</td>
<td>566</td>
<td>20</td>
</tr>
<tr>
<td>Priceline</td>
<td>6,528</td>
<td>2,083</td>
<td>613</td>
<td>-</td>
</tr>
<tr>
<td>TripAdvisor</td>
<td>-</td>
<td>-</td>
<td>1,115</td>
<td>377</td>
</tr>
</tbody>
</table>

Source: Expedia, Priceline, TripAdvisor 2015 Form 10-K

The primary revenue segment depends on the business model of the company. Priceline focuses on agency revenue, Expedia on merchant revenue, and TripAdvisor is driven by advertising.
The primary source of these revenues for the companies was from hotels. For Priceline and Expedia, room nights booked was drastically larger than airline tickets booked and car rental days. However, the companies do not break out revenues for all the room nights booked versus airline tickets or rental car days. TripAdvisor derived 84.7% of its advertising revenue in 2015 from the hotel segment.\(^7\)

**Growth Prospects**

Growth for the last few years has been driven by the shift from booking travel offline to going online. This trend has been slowing. Holdouts are not likely to shift from traditional travel agencies en masse to OTAs.

Growth is still growing, but the large growth numbers seen in the past are not likely to continue. Forward growth numbers will start shrinking, especially as internet penetration worldwide increases. Eventually digital sales growth will equal total sales growth as equilibrium is achieved.

Additionally, there is competition for online users between OTAs and the providers themselves. The declining growth in the chart above is being divided amongst a large number of firms. All the airlines, hotel chains, and car rental brands have websites that allow customers to book travel arrangements. Loyalty programs ensure that a certain group of customers have no reason to use the OTA search engines to find the right deal.\(^8\)

Travel markets that are growing due to an increase in disposable spending present a solid opportunity for
growth. Asia-Pacific and Africa present large growth opportunities. There is little the OTAs can do to create the disposable income and travel infrastructure required to grow these markets, however should these markets start to grow they present a solid opportunity to enter into new markets. North America, Western Europe, and Asia-Pacific represent the largest current markets. Asia-Pacific has many local players such as Ctrip, but through acquisitions the major OTAs can grab more of the revenues from this region. Priceline’s acquisition of Singapore-based Agoda.com is an example of these efforts.

China is seen as the most important growing market, but it is dominated and restricted to Ctrip. There is also potential for growth as more people in emerging economies come online. International markets will keep revenues growing, but the high growth driven by the richest economies will diminish. This does not mean declining growth in the rich economies, but a growth rate closer to the economic growth rate dependent on the health of the travel industry.

**RECENT DEVELOPMENTS**

**Global Unrest and Crises**

Terrorism is the ever present threat of the modern world, but in the aftermath of a terrorist attack travel is depressed. If the attack happens in a key area, it can take a very long time for the local travel market to recover. Paris was an important city in terms of booking, and after the Paris attacks Priceline and Expedia were hammered over tourism concerns. Paris is a key destination as well as a city full of potential travelers, a disruption to this could hurt revenues from Europe.

The decline in oil prices could further destabilize the Middle East further it could have significant ramifications, and this presents a serious risk that is not quantifiable. It is dependent on whether unrest increases terrorism, or if it blows over without much external impact.

There is no way for this risk to be managed. It must simply be borne when it comes to the fore. The migrant crisis sweeps over Europe and the Zika virus strikes fear into potential mothers, which are two different problems affecting two different continental markets. The effect of these has not yet been fully ascertained but present a risk. Dangerous areas do not draw the bulk of travelers. Potential travelers may stay home than risk their safety elsewhere.

**Strengthening Dollar**

A strong dollar is a mixed bag for the industry. For companies that derive a large amount of revenue from overseas such as Priceline it can cause a decline in revenues. A stronger dollar could spur US travel overseas, but each release of job and GDP numbers is watched closely for US weakness or unambiguous strength.

The perception among potential travelers is as important as the actual strength of the labor markets and the economy. Scared workers might put off vacation, and the underemployed are not as likely to travel.

**MARKETS AND COMPETITION**

The online travel agency industry, where the company collects a fee for being an intermediary, is a very mature industry with only two main players who compete for volume of transactions, but avoid compressing margin further. The offerings among the companies do not differ substantially, as they offer platforms to reach consumers. For a site like Booking.com there is no cost to list a property, because the fee is generated when the rooms are booked. Advertising may claim cheapest airfares, which can be true in the narrow opaque market, or the best selection, but the reality is the companies aim to be the first site visited to book travel.

Prices are set by the service providers. Competition among service providers can be intense, like in the airline industry. OTAs are somewhat insulated from the effects of this competition, higher costs mean higher fees per transaction even if volume goes down. Supplier power in this industry is interesting, because there is not much incremental power for small changes. However, the suppliers can pull their listings and block the search algorithms. Since time is an issue in this industry because idle capacity is revenue lost that cannot be regained, ever, reducing exposure to consumers is rare. Soft methods like loyalty programs are used.

Starting one of these sites is not a difficult or expensive proposition, but it can be very difficult to unseat known brands. Also, the standard practice in the industry is to buy potential competition very early as they gain a strong user base.
There is a risk of substitutes. To a lesser extent companies like Airbnb pose a threat, but the greater threat is service providers who seek to have users book directly. Google’s flight service also poses a major risk. It functions much like Kayak, but when it directs you to book on the airline’s website it gains no commission.

**Heavy Consolidation**

The industry is at a stage that direct competitors tend to be swallowed up. The cost of entering the industry is very low, simply requiring a website infrastructure and a search algorithm. New entrants that carve out a customer base are acquired, but the website brand is usually maintained.

There is even consolidation among the larger companies in the industry as Expedia’s acquisition of Orbitz shows. Orbitz was third in the industry when the acquisition occurred. Many of the most known websites for travel booking are owned by Priceline or Expedia. Expedia’s acquisition of Orbitz closed in early 2015, and Expedia has already acquired HomeAway a vacation rental website.

<table>
<thead>
<tr>
<th>Company</th>
<th>Websites</th>
</tr>
</thead>
<tbody>
<tr>
<td>Priceline</td>
<td>Booking.com, Priceline.com, Agoda.com, KAYAK, RentalCars.com, OpenTable</td>
</tr>
<tr>
<td>Expedia</td>
<td>Expedia.com, Hotels.com, Hotwire, Travelocity, Egencia, CarRentals.com, Orbitz.com, Cheaptickets.com</td>
</tr>
<tr>
<td>TripAdvisor</td>
<td>TripAdvisor.com</td>
</tr>
<tr>
<td>Ctrip</td>
<td>Ctrip.com</td>
</tr>
</tbody>
</table>

*Source: Expedia, Priceline, TripAdvisor 2015 Form 10-K*

Table: Parent Companies and Major Brands

Hotel room nights are the largest share of gross bookings. Even TripAdvisor’s advertising revenues are driven by...
hotel bookings. Room nights booked are also a very fast growing area for the companies. Priceline’s revenue is more dependent on hotels. Expedia is trying to catch up by aggressively expanding the properties they have in their network.

**Peer Comparison**

Advertising expense for Expedia and Priceline does not generate travel demand, but drives customers to their sites. The companies compete for web clicks as well as transactions. When Expedia bought Orbitz it became the largest OTA in the US by visits, and is larger by gross bookings. However, Priceline’s net income outweighs Expedia’s substantially due to dramatically lower costs.

The key metrics for the major companies in the industry are:

<table>
<thead>
<tr>
<th>Company</th>
<th>P/E</th>
<th>P/S</th>
<th>ROE</th>
<th>Hist. 3YR EPS Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Priceline</td>
<td>26.4</td>
<td>7.0</td>
<td>37.6%</td>
<td>22.0</td>
</tr>
<tr>
<td>Expedia</td>
<td>19.0</td>
<td>2.5</td>
<td>23%</td>
<td>45.6</td>
</tr>
<tr>
<td>Ctrip</td>
<td>36.2</td>
<td>12.13</td>
<td>9.50%</td>
<td>22.3</td>
</tr>
<tr>
<td>TripAdvisor</td>
<td>48.1</td>
<td>6.13</td>
<td>15.61%</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: Factset

**ECONOMIC OUTLOOK**

The main economic factors that impact the OTA industry are global GDP growth and exchange rates. The price of oil was considered a major factor, but the expected spike in travel has yet to materialize in meaningful ways that are clearly identifiable. Many of those macroeconomic factors cannot be judged in the moment, but require quite a lot of time to pass.

Global GDP growth tends to be uneven. Europe is struggling, but Asia continues to grow. Disposable income is growing rapidly in China and India, but in the US many are waiting for political action to revitalize the middle class. There are many factors that influence whether people travel even when economic growth is strong. The unstable political situation in different regions can hamper growth. Lower GDP growth may reduce leisure travel, but if economic growth is strong elsewhere it might increase business travel.

Exchange rates provide more immediate effects due to the substantial international revenues. A stronger dollar may spur US travel overseas, but it can hamper travel into the United States. It can also reduce overseas revenue on a currency adjusted basis. While this is not indicative of weakness in the business itself, a strong dollar will skew earnings results. The recent rebound in the Euro towards $1.15 is driven more by dollar weakness after further interest rate increases were put on hold. If concerns continue to mount regarding Europe and the world as a whole the decline of the Euro could continue. The US dollar is seen as a safe haven currency, surpassed only by the Japanese Yen. Euro weakness will not hurt intra-Europe travel, and may spur people to visit the Eurozone due to the weaker currency. However, travel out of Europe would suffer.

A low oil price would help travel, though the nature of the travel market in Europe means less impact. The US has lots of travel by car, which is fuel inefficient. Europe’s trains and planes insulate it somewhat from the price of oil. However, jet fuel and oil are still linked, and the price of jet fuel has fallen. Oil being a basic input for much of the economy has an impact, even if it is simply to increase the disposable income of individuals. We see oil stabilizing at around $40-$50.

**INVESTMENT POSITIVES**

- Gross bookings have continued to grow. Recent stumbles have been due to short-term events such as terrorism or regional instability. If gross bookings continue to grow the recent fear of a slowdown for the OTAs will likely dissipate.
- Passenger demand growth is expected to remain strong, which could help OTAs.
- The Chinese market is strong, and each company is adding more properties to increase room nights booked
- Oil will stabilize at levels lower than it has been at before 2014. This will support an increase in travel volume, even if travel volume remains flat on an oil-adjusted basis. Oil remains one of the few macroeconomic positives for the travel industry.

**INVESTMENT NEGATIVES**

- An unstable global environment can hurt the travel industry. There are still many areas of stress and unrest that could spin off into more problems.
A stronger dollar poses some risk, because it can spur travel but also skew results. If the dollar rally resumes Expedia and especially Priceline may face headwinds.

Most customers have already made the shift from offline to online. Revenue growth was bolstered by that shift. Presently, the OTA market is likely to grow at a similar pace to the travel market as a whole.

Increased competition from the providers of travel services themselves may eat into bookings. Airlines, like Delta, and hotel chains, such as Starwood, seek to have customers book directly from their sites. Starwood’s acquisition of Marriott creates a very large and powerful chain. Travel service providers try to use loyalty programs to draw customers directly to them. This will take business away from OTAs.

The OTA industry is facing many headwinds that could hurt growth. The effects of global crises are unknown that this time. The price of oil was supposed to boost travel growth, but this has not materialized. The competition in China will be intense, which will put pressure on all the companies. With concerns of a slowdown in China as well, though not one that will decrease disposable income among the middle class, this increased competition could hurt overall profitability.

In the larger economies, internet access has been high for many years and conversion from offline to online has largely played itself out. There is also increased pressure from smaller players who in the high end travel market offering concierge-style booking of luxury travel. The increased competition from travel services providers is also likely to harm the OTAs, since the providers are absolutely necessary for the OTAs but the service providers have their own in-house substitutes for the OTAs.

Our sell recommendation is primarily due to the uncertainty surrounding the global travel market. There have been events where the fallout is not yet clear, such as the terrorist attacks. The likelihood of another terrorist attack is also unknown.

Latin America is not yet a key market, though travel to and from is more important than intra-Continental travel currently. The Zika virus epidemic may have multi-year repercussions. It is the uncertainty that forms the basis for our sell recommendation on the industry. The travel industry is extremely sensitive to macro concerns, and there is no upside associated with this uncertainty since the stocks continue to rise due to monetary policy.

KEYS TO MONITOR

- Growth of gross bookings is one of the key factors to look for each quarter. This is crucial to the industry if it is to continue increasing top line growth. Growth in Asia is specifically important to consider.
- Watching the value of the dollar will be important. If the rally resumes it could skew earnings downward, but if the dollar weakens it could boost earnings.
- Travel alerts should be watched as they crop up. Zika virus is currently roiling the travel market, but there is a lot of global volatility.
- The risk of terror does not abate, and even if it does it will not be evident until far after the fact. Sentiment can be tough to change especially when it comes to fears regarding personal safety. While a reduced risk of terrorism may change the outlook it would be tough to identify any specific component to watch to monitor this.
- Britain exiting the EU is another risk that may not have a significant impact on operations except through sentiment and workers concerned about the impact deferring travel. It will probably have an effect on the Euro despite Britain not being in it. The potential trade consequences could weigh on the currency. Britain not exiting will have little material impact, since it is a continuation of the status quo. However, it may improve general feelings regarding Europe’s economic health and political stability.

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7. TripAdvisor 10-K 2015 – Factset


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