ROGER MONTGOMERY

Re-inventing the way you invest

A Montgomery White Paper

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OnTheHouse

Can anyone beat Realestate.com.au at their own game?

Success could make it a takeover target for one of the big online property advertisers.

We first published some thoughts about OnTheHouse in December elsewhere. Here we will put much more meat on the bones.

For investors with a little room for some additional risk, the online real estate portal and data company OnTheHouse is worth investigating. The outcomes, however, are likely to be binary. Either a big win or a big loss – and little middle ground – will be the result of a foray here, so be sure to seek and take personal professional advice.

Investors in OnTheHouse Holdings' 2011 float must have worried that they had bought the worst house in the street when its $1 issued shares tumbled to 33 cents within six months of listing.

The Brisbane-based company raised $55 million and listed on ASX in June 2011. Of that, $49.8 million was used to acquire real estate agent software providers, Console and PortPlus.

OnTheHouse's $81.5 million capitalisation at listing was arguably based more on the capital it needed to buy Console and PortPlus than on future earnings. Small Initial Public Offerings (IPOs) often base their valuation on how much money they need, rather than the return they can generate on that capital.

The property information company was another example of why it can pay to look at floats well after listing – at least two years – when there is history as a listed company, more chance to see if the prospectus was reliable, and after restricted securities have come out of escrow and can be sold.

Like houses at an auction, IPOs, especially those vended by private equity firms, may be "dressed up" to inflate the valuation. It is not until the new owners move in that problems emerge and the IPO price paid seems ridiculously high in hindsight.

More to the point, why buy unproven listed companies in a volatile share market when so many established ones have traded below their intrinsic value since the 2008 Global Financial Crisis?

Analysis shows almost four in five floats – out of more than 450 – have lost money for investors since August 2007. Yes, there have been stellar exceptions: Carsales.com, TradeMe Group, Corporate Travel Management, and NextDC come to mind. But we're talking about a handful or two of investment-grade industrial floats that have had sustained share price gains over five years, against several hundred dogs.

With those odds, value investors could easily avoid the IPO market.

We could end this column on that note. But let's keep going.

The vast majority of IPOs since 2007 have been for speculative mining explorers anyway, and the old problem of stock in the best industrial floats being locked away for clients of sponsoring brokers seems alive and well.

Yet this lack of interest in the IPO market creates an opportunity for patient value investors who can wait for the heat to come out of floats and buy after listing, when prices are much lower than their exuberant highs and even lower than conservative estimates of intrinsic value. The market often banishes an IPO with a slumping share price to the small-cap graveyard, and analysts and investors stop looking.

OnTheHouse looked like it had one leg firmly planted in that graveyard when its shares were 33 cents and it was the 92nd worst-performing float (out of 103) by the end of 2011. Its first year as a listed company was tough, but there was a lot to like about its strategic progress.

OnTheHouse's forecast price-earnings (PE) ratio was a whopping 41.6 times at listing. Put another way, investors paid $81.5 million for a company with a forecast after-tax net profit of $2 million in FY12, and earnings per share of 2.4 cents. Even by internet stock standards, the market valuation some people were willing to ascribe to the company was rich.

One guess is that OnTheHouse needed the capital to buy Console and PortPlus quickly, and integrate them with its existing consumer website, to capitalise on the opportunity of building a next-generation property advertising website with free property valuations and data. Speaking personally, if I had the capital and the faith in the business, I would not float it as early as it had been.

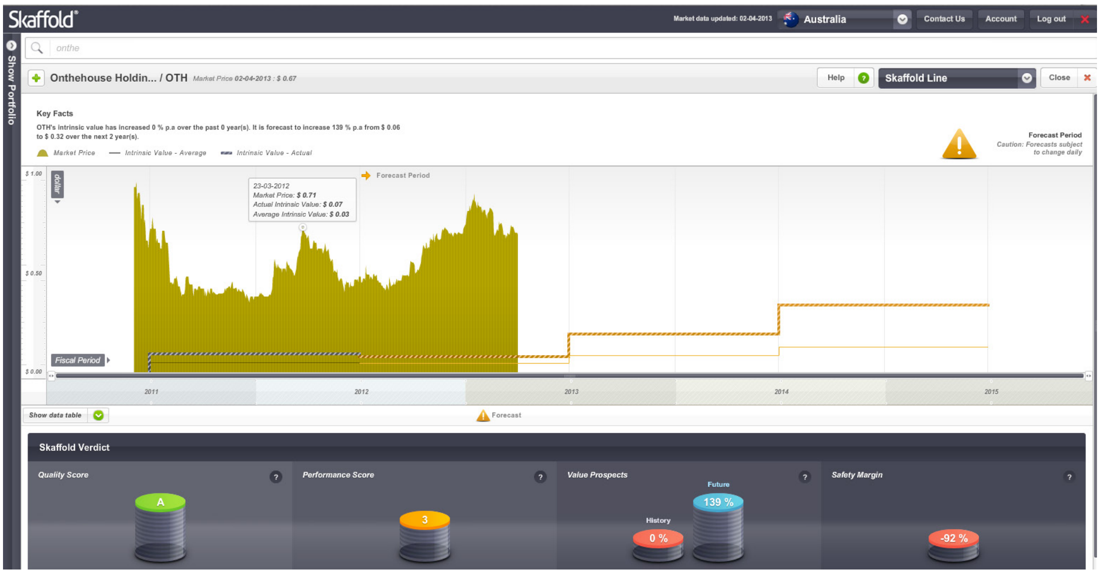
With RBS Morgans and Wilson HTM as joint underwriters, there was plenty of firepower to sell OnTheHouse's IPO to retail investors. Other successful Queensland-based floats, such as Corporate Travel Management, NextDC, Mastermyne Group and QR National, would have whetted appetites.

Also, the outstanding success of the big internet stocks – Seek, REA Group, Carsales.com, Webjet, and Wotif.com – had investors looking for the next batch of emerging online 'game-changers' – there's that label again.

iProperty Group has done well over the past three years as it aims to become the realestate.com.au of South East Asia. A related venture, iCar Asia, wants to be Asia's Carsales.com, and floated last year year. OnTheHouse has been promoted as a serious challenger to REA Group's dominance in online property ads in Australia, and a potential industry disruptor as well as game changer.

OnTheHouse was clearly overpriced at its $1 issue price, and possibly more fairly priced when it slumped to 33 cents in a brutal market (see Figure 1, which shows a 2015 valuation estimate of 32 cents). It has since rallied to 68 cents on the back of decent earnings growth, strong gains in website traffic, acquisitions and more confidence in its business model.

Figure 1. Skaffold Valuation Line Chart. (Source: Skaffold.com)



OnTheHouse was modelled on US site Zillow.com, which listed on NASDAQ in 2011 and is capitalised at US$878 million. A similar US site, Trulia.com, listed on the New York Stock Exchange in September last year and is capitalised at $US490 million. UK site Zoopla.co.uk has a similar offering.

These sites use free property data to attract visitors, and sell property leads from potential buyers and sellers to real estate agents. Although their early success has impressed, Zillow, Trulia and Zoopla operate in much more fragmented online property advertising markets than Australia.

OnTheHouse believes that the revenue model in online property advertising will move from paying for classified advertising to performance-based models based on pay-per-lead services. In some ways, OnTheHouse resembles Carsales.com, which provides data to car dealerships.

The logic is powerful: providing current, free property data, in addition to listings, gives OnTheHouse a point of difference over larger rivals REA Group and Fairfax Media's Domain. In turn, this lures traffic to OnTheHouse and creates buying and selling enquiries.

The "eyeballs" from that traffic are used to sell advertising. Suncorp, for example, signed up in March for a 12-month sponsorship. The big prize is selling leads from potential property buyers and sellers who seek valuations and other data to real estate agents, for a fee.

OnTheHouse also provides real estate agent software and sells real estate data, but the main game is online property advertising, which was worth $283 million in 2010 and is growing rapidly, according to Frost & Sullivan. The market for real estate agent software and data was worth a combined $150 million.

OnTheHouse could be one of the rare companies that can provide multiple solutions across the value chain. Providing rich data empowers consumers to make more informed property decisions, and thus lifts their level of engagement on the website, which is great for advertisers and sponsors. As more enquiries are made, more leads go to property agents, who get a better return on their marketing dollars.

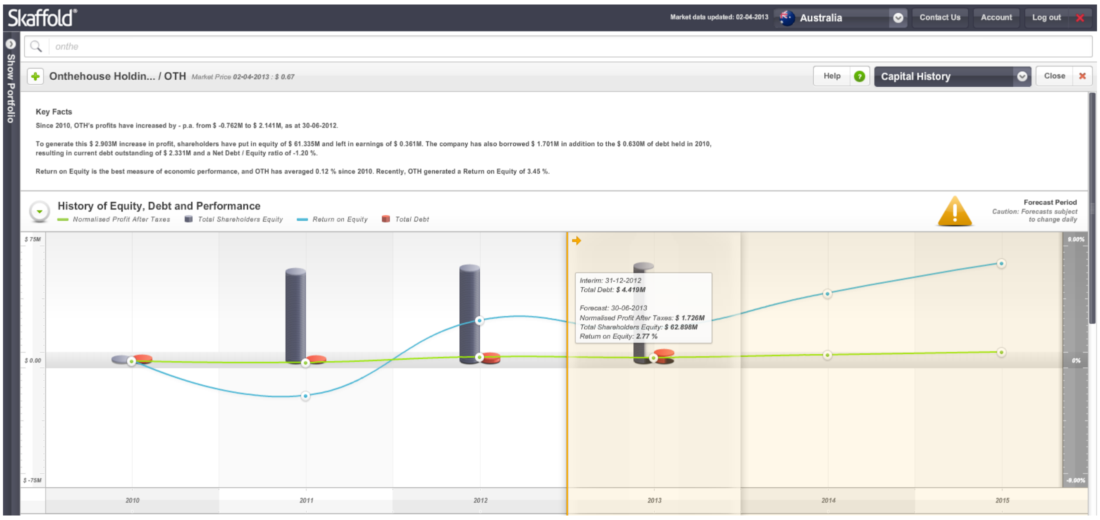
It's all about scale and data: achieving a sufficient mass of site visitors should enable OnTheHouse to monetise its real estate database quickly. In September, it paid $3.5 million to acquire another 50 per cent, and move to full ownership, of well-regarded property data company Residex.

Residex's 20-year history gives OnTheHouse a huge database to work with and, more importantly, secures an important strategic asset. Residex is a key player in the property data market, along with RP Data, Price Finder and the Fairfax-owned Australian Property Monitors.

OnTheHouse's strategy is working: revenue rose 22 per cent to $20.3 million in FY12, and net profit of $2.1 million was slightly ahead of prospectus forecasts. Operating cash flow soared from a negative $613,000 in FY11 to $6.4 million in FY12 (See Figure 3.), with net debt at just $1.3 million. OnTheHouse should be able to acquire smaller business and invest for faster organic growth without taking on huge debt or diluting shareholders with excessive share issuance.

As Figure 2 shows, the company has little debt (red columns) and rising return on equity (blue line) – albeit from a very, very low base.

Figure 2. Skaffold Capital History Screen. (Source: Skaffold.com)



Website traffic is growing strongly: there were more than 1.2 million unique browsers in August 2012 on OnTheHouse, and 2.5 million property reports generated. Brokers have described OnTheHouse as reaching a "sweet spot" where it now has enough traffic to sell enquiry leads to agents and ramp up earnings.

The company has only scratched the surface with its traffic and property data. Distributing it through mobile devices has great potential, as does selling it beyond the property industry to banking, conveyancing and other markets that rely on property transactions.

The main doubt is whether Australia can ever accommodate three large property websites. History shows that the leading advertising website in an industry enjoys a sustained gap over its nearest rival – think Seek, REA Group, Carsales.com and Webjet. More site users attract more advertisers and content, which in turn attracts more users – and makes it near impossible for rivals to close the gap.

REA Group easily dominates Australia's online property advertising market, and the number-two site, Domain, could be reinvigorated as Fairfax Media aggressively chases its digital future. It is hard to see OnTheHouse ever becoming the dominant property advertising site, given this competition.

Another problem is the subdued state of Australia's property market and a struggling real estate industry. A weakening property market could dampen traffic growth at OnTheHouse.com.au, and reduce demand for real estate agent software and property data sales.

However, REA Group's success this year shows how property advertising sites can continue to grow by taking market share off printed publications, and how dominant online advertising sites have significant power to lift prices and boost revenues, if volumes slow.

Figure 3. Skaffold Cash Flow Table for OnTheHouse. (Source: Skaffold.com)

Onthehouse Holdin... / OTH Market Help Cash Flow

Hide data table

	2012
Cash Flow Ratio (> 0.80 Preferred)	3.00
Reported Net Profit After Taxes (Millions)	$ 2.141
Cash Flow Generated From Operations (Millions)	$ 6.422
Cash Flow From Investing Activities (Millions)	$ -5.782
Cash Flow After Investing (Millions)	$ 0.640
Cash Dividends Paid (Millions)	$ 0
Other Financing Cash Flows (Millions)	$ -1.528
Foreign Exchange Effects (Millions)	$ 0
Funding Surplus / (Gap) (Millions)	$ -0.888
Equity Capital In / (Out) (Millions)	$ 0
Debt In / (Out) (Millions)	$ 2.207
Total Capital In / (Out) (Millions)	$ 2.207
Cash Movement (Millions)	$ 1.319
Bank Account Open (Millions)	$ 1.747
Bank Account Close (Millions)	$ 3.066

Another challenge for OnTheHouse is brand awareness. At some point, it will have to spend millions on marketing to raise its profile. It has done exceptionally well to attract website traffic through search-engine optimisation techniques, but a bigger advertising campaign will eventually be needed – or a chat with Jumbo Interactive!

Skaffold rates OnTheHouse an A3 company for quality, grades its business performance as 3 (average), and believes it is significantly overvalued at current prices (68 cents). Skaffold's valuation assessment seems harsh, although not surprising, given that it has only a year of earnings for OnTheHouse (as a listed company) to work with and return on equity has been little more than interest on a term deposit.

Notwithstanding the fact that the price exceeds Skaffold's intrinsic value estimate, it would not surprise me to see OnTheHouse edge towards its $1 issue price – if the property market recovers and starts making a lot of noise in the media, its website traffic also hurtles higher, and brokers and small-cap fund managers pay more attention, putting buy recommendations on the stock.

Disciplined value investors obviously have to wait for justification and an alignment of signals from both the company's performance and valuations. Even more speculatively, if the company continues to disrupt its industry, OnTheHouse might become a takeover target for one of the big online property advertisers. It could give Fairfax's Domain more punch to take on REA Group, and REA Group more data to enrich its website content and entrench its leadership position.

Either way, OnTheHouse has strategic value and positioning as well as an open share register. It looks like a company that is worth much more in the hands of a big player than as a standalone operation.

Roger Montgomery

The Montgomery [Private] Fund and The Montgomery Fund are shareholders in OnTheHouse.

A Note From Montgomery Investment Management.

Dear Value Investor,

Please find below our updated returns to the end of March. With many of the companies we have purchased at lower prices now reaching our intrinsic value estimates, and in some cases exceeding them, there is not a lot of activity at Montgomery. Indeed it seems investors would be well served to be prepared. Cont/d-

PERFORMANCE to 31 MARCH 2013

The Montgomery Fund (for retail investors)

	Inception	To	Total Return
	17/8/12	31/3/13 (*after expenses)	
The Montgomery Fund	1.0000	1.2649	+26.49%*
S&P/ ASX 300	33,899.10	39,803.3	+17.42%
Accumulation Index			
Out/ (Under) Performance			+9.07%*

The Montgomery [Private] Fund (for wholesale investors) (1).

	Inception	To	Total Return
	23/12/10	31/3/13 (*after expenses)	
The Montgomery [Private] Fund	1.0000	1.3202	+35.72%*
S&P/ ASX 200 Industrials	27,751.3	31,106.92	+12.09%
Accumulation Index			
Out/ (Under) Performance			+23.63%*

(1). The Montgomery [Private] Fund went ex 2.8771 cents per unit distribution on 30 June 2012.

For more information about either Fund, please visit www.montinvest.com or call David Buckland on (02) 9692 5700.

We continue to be cautiously optimistic about the prospects for the businesses we own, and look forward to reporting season when we expect some positive updates. We note many investors we have spoken with are holding off investing in the stock market until a 'correction' occurs. We hope they are right as we are relatively heavily weighted again in cash. The only problem of course is that experience has taught us that when everyone is holding cash on the sidelines, that cash, labelled as it is for additional investment, usually limits the extent of any sell off. Moreover the lack of any desire to sell existing holdings also limits the magnitude of any predicted sell off.

In other words, we are more optimistic than pessimistic and acknowledge that with few cheap high quality stocks available we require either 1) a sell off in prices, or 2) profit upgrades that lift valuations, before we can meaningfully invest.

If you are considering investing in The Montgomery Fund, speak to your advisor now. Perfect timing is highly desirable but rarely achieved.