Is REA MOVE-ing in the right direction?

by Roger Montgomery

Key Points:

- *News Corporation and REA's takeover offer via a joint venture for US-based online real estate business Move cost US$950 million – which could be considered a fairly high price, given its earnings.*
- *News will be able to shift Move to its platforms to increase traffic, however the US market isn't as straightforward as the Australian market is.*
- *Should the stars align for Move, it could become highly profitable (think hundreds of millions in US dollars), and REA would own a 20% slice of this action. But a lot of luck is still required.*

One question that has persisted for a while with REA Group Limited (REA) is its retained earnings, i.e. for a capital light, debt-free business, where would these excess cash flows be reinvested? As of June 2014, the firm had accrued A$253.8 million of cash on its balance sheet – almost half of its total assets.

Moving opportunities

A US listed firm with a volatile earnings history, online real estate business Move Incorporated was not amongst the first of opportunities for these cash flows that came to mind for most analysts. A summary of its revenue and earnings was taken from its 2014 10K report and presented below.

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(In thousands, except per share amounts)				
Consolidated Statement of Operations Data:					
Revenue	$ 227,033	$ 199,233	$ 191,724	$ 197,503	$ 212,009
Net income (loss)	574	5,625	7,260	(15,472)	(6,946)

To put its market position into context, Move had been competing as the number three player in a US$14 bilion market against its larger rivals Trulia and Zillow Incorporated (NASDAQ: Z) for many years. We believe it was becoming clear to many that the entity with the largest marketing budget, would have the best chance of success of ultimately winning market dominance. In our view, Move would have likely struggled to win this contest against its larger rivals.

Enter News Corporation (ASX: NWS) and REA's takeover offer via a joint venture. The offer price was US$950 million – which could be considered a fairly high price given its earnings. News would put up 80% of the cash with the remainder financed by REA (via some of that cash noted earlier).

Now you may ask, will Move ever earn enough to generate an acceptable return on its acquisition price? The first thing to take note of is that the purchase price is likely lower than it would first seem, Move's earnings history left it with many millions of accumulated tax losses which can be offset against future taxable income. This detail is buried in News' 2014 10-K filing in the US and is recorded on its balance sheet as a deferred tax asset (on page 106 of the report). The exact value of this asset will be subject to future review but it does make the price a little more palatable.

Next, we note NWS's strategy to improve the company's prospects. In a nutshell, News plans to advertise Move across its vast media portfolio and hence drive traffic to the website. This represents a great deal of marketing worth millions (for free) hence providing it with one competitive advantage over its rivals.

There's likely a lot more going on behind the scenes, but the overall strategy is fairly straightforward; by increasing website views/viewing time, this will theoretically generate more leads for participating agents and hence create a justifiable case for why advertising on the Move website is worth paying for.

In fact, it's exactly what occurred in the Australian market as REA grew into the behemoth it is today.

US peculiarities

However, the US market isn't as straightforward as the Australian market is. Australia is largely a vendor paid market, i.e. one where the home seller will typically pay for advertising on top of the agent's commission, whilst in the US, the agent generally pays for all advertising. It's true that agents in the US earn approximately 6% on each housing transaction, as opposed to the standard 2% in Australia, however the differences in median housing prices (circa A$600,000 in Australia, U$200,000 in the US) largely cancel this out and hence cap marketing budgets. In the Australian case, the budget is more flexible since the homeowner is about to become flushed with cash from the sale of their property.

Hence before we see any 'premiere'-like ads popping up on Move for the prices we're used to in Australia, US agents will need a significant amount of convincing about the potential returns on their more scarce marketing dollars.

Luckily, it's known that many US agents are already spending significant sums of advertising dollars online via email marketing and their own websites (Google search terms), therefore an industry wide transition to portals such as Zillow and Move is unlikely to prove a huge leap, as long as any spending generates an acceptable number of leads.

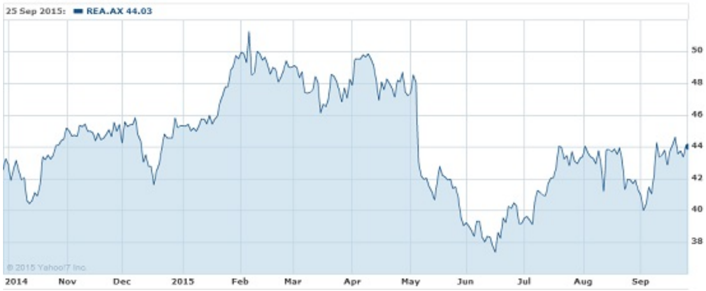
The high level of marketing spend required to generate customer awareness creates a large barrier to entry. As such, provided no other incumbents can match Move and Zillow on the value of marketing spend, it seems likely that they'll be able to consolidate the remainder of the market, win significantly more eyeballs over time and concentrate online lead generation in their hands.

This will mean little, however, if new market entrants pop up that are willing to fork out these marketing dollars and, through competition, begin to erode any abnormally high levels of profitability (should they ever be reached).

As such, the Move and Zillow will need to become the beneficiaries of habitual use amongst the population of US homebuyers. Habit is a good protector of market share and profits, meaning that should the stars align on all these variables for Move, it would likely become highly profitable (think hundreds of millions in US dollars), and REA would own a 20% slice of this action.

However, habit is also notoriously difficult to cultivate and attention from property browsers is rather fickle. It sounds like a pinch of luck may be required here.

REA Group (REA)



Source: *Yahoo!7Finance, 28 September 2015*

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