REA owns the space

A competitive advantage sets it for long-term performance, writes Roger Montgomery

REALESTATE.COM.AU (ASX: REA) isn't a business that traditional value investors would love. It has a historical price-to-earnings ratio of 28, high growth hurdles, earnings seemingly linked to an unpredictable and fluctuating housing market (the list goes on) ... yet on closer inspection we believe the investment case for REA is strong and the potential for earnings growth is high.

For those unfamiliar, REA operates www.realestate.com.au where real estate agents can list the properties of their clients (the vendors). REA charges a subscription fee from the agents for access to the website as well as a fee for each property listing (depth revenues).

Prices for property listings range from a few hundred dollars for a "feature ad", to about $500-$1500 for a "highlight ad" and thousands for a "premiere ad". It's important to note that these listing costs are passed from the agents to the vendor – costs of which are marginal relative to the ticket price of their property.

Prices for listings on REA have lifted by about 20% to 50%pa over the past several years. The next pricing review is expected in February, and we asked the question: "How much further can REA raise the prices of its ads?" This is a poser, but answering it will provide a guide as to how much further the company can grow.

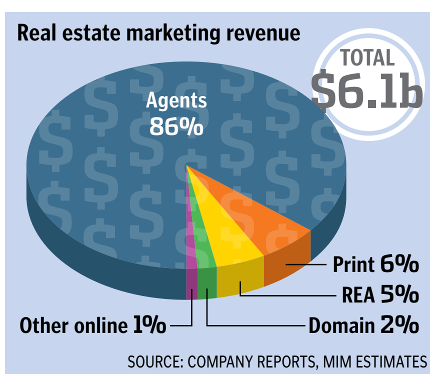
We believe the best way to answer is to consider the marketing budget of a prospective house seller. Of course there's REA, but then there's also Domain (owned by Fairfax Media (FXJ), other online listing sites, newspaper advertising and the seller is most probably using a real estate agent who'll take a commission.

We've developed a fairly good picture of what the real estate advertising "pie" in Australia looks like (right). The shares of REA, Domain, print (newspapers) and "other online" are sourced from reports while agent revenues have been estimated by taking 2% (standard commission for a real estate agent) of the total transaction volume in Australia.

Notably despite REA's prominence, it earns only 5% of all market revenues. We believe the value REA provides to housing transactions is considerably higher than that for most market segments, given it connects sellers with potential buyers.

What we mean by this is, because REA has a strong value proposition, it can (over the years) charge higher prices; it has a competitive advantage afforded to it by its "network effect", i.e. the site attracts the largest audience of homebuyers and searchers in the market (by some magnitude) and hence "leads" for agents (and drives their commissions from sales).

Thus there is an incentive for agents to continue listing properties and advertising on REA and REA's competitive advantage and ability to increase prices grows stronger, in a self-reinforcing loop.



Note that it's not always the case that value provided equals revenue earned, but it can do so when a company holds a strong competitive advantage, as in this case.

Of course, revenue equals price multiplied by volume, and all this will mean little if the number of listings on REA drops substantially. CoreLogic's July issue of the *Housing and Economic Market Update* suggests that over the past year the number of listings across the market has fallen by 3.9% Australia-wide.

Interestingly, while this trend persists, the number of paid highlight and premiere listings on REA has increased. Due to their high price, these two generate the bulk of REA's depth advertising revenues and their popularity bodes well for its bottom line.

REA's investment case is dependent on it holding its market position as the No. 1 provider of real estate advertising services. Domain is challenging this dominance with a campaign to increase its listings.

What's critical is to understand what REA's offering is. It's not just listings – it's the ability to create a lead for a real estate agent that produces a sale for the vendor.

To achieve this, the website operator must draw the largest audience and maximise the amount of time visitors spend browsing properties. REA has succeeded in doing this for a long time and (at least by our estimates) it appears they are continuing to do so despite the heightened competition.

At Montgomery we avoid forecasting the short term and focus on long-term value. As such, while its 2014-15 result may result in a higher or lower share price, we are confident that REA's long-term earnings prospects are very bright indeed.

The Montgomery Fund, The Montgomery Private Fund, The Montgomery Global Fund & The Montaka Global Fund hold positions in REA Group.

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