TRADER EXTRA

Whither Zillow?

Why the online real-estate market behemoth could fall 25%.

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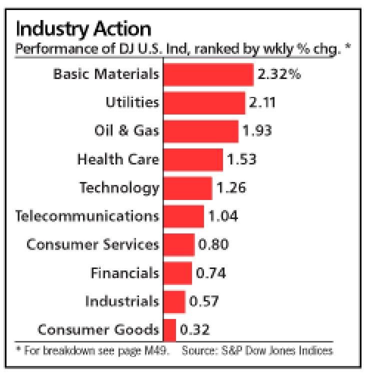
After buying rival Trulia a year ago for $2.5 billion in stock, Zillow Group is the online real-estate market behemoth, with a 70% market share in the mobile category. Its class A shares are up about 40% recently to $24.

While it's a good bet most U.S. home seekers have visited its Websites, Zillow's nosebleed stock valuation and meager prospect of profitability in the foreseeable future makes the stock risky and disproportionately vulnerable to even small hiccups.

The Seattle-based firm's revenue growth is robust, but the Trulia deal makes it difficult to evaluate the underlying organic growth. Zillow's "as reported" figures compare 2015 results including Trulia since February to a pre-merger Zillow in 2014. And the company furnishes pro forma data, where combined Zillow-Trulia results for both 2015 and 2014 are compared.

What's missing are 2015 Zillow (ticker: ZG) results excluding Trulia. When asked, a Zillow spokeswoman replied that following the merger, costs were not separated internally. Zillow declines to give the revenue breakout from the merger close to September 2015, when integration was completed.



Realtor.com, owned by Dow Jones' parent News Corp. (NWSA), competes with Zillow.

In 2015 Zillow grew revenue 18% to $680 million pro forma from 2014. Average monthly unique users soared 61% to 124 million, while real-estate revenue, 75% of the total, rose 35% to $502 million, both pro forma. Most of the gains are derived from Trulia, and investors can't tell how much, if any, growth came from Zillow alone.

The market is ignoring other important negatives that could drop the stock toward its recent low of $17.

Zillow is unprofitable, for one. Based on generally accepted accounting principles (GAAP), losses have worsened each year since 2012. That's a function of expenses growing as fast or faster than revenue, says David Trainer, president of New Constructs, an independent accounting-research outfit.

Including Trulia, revenue growth averaged 77% over the past four years, and total expenses, 70%. Marketing and general and administrative costs, in particular, have ballooned 85% over that period, adds Trainer, who says Zillow's underlying economics are declining and the stock is much overvalued.

To find the negative trends, investors must toggle between press releases. For example, in the fourth quarter press release Zillow's average monthly revenue per advertiser was up 29%, to $438, pro forma, driven by "high-performing agents buying more advertising," rather than price increases.

Agent advertisers, along with unique users, are key growth drivers of real-estate revenue. Agent numbers, however, have fallen sharply. In the fourth-quarter release Zillow had 92,366 agent advertisers at year-end 2015, including Trulia. There's no comparison figure—something the company previously presented, pre-merger.

Agent numbers have dropped 11%, based on the 2015 first-quarter release, which put agent advertisers at 103,415 on March 31, after elimination of duplicates caused by the merger. Zillow counters that it has encouraged low-performing agents to leave and higher-performing agents are spending more. But reducing agents doesn't bode well, particularly if the housing market cools.

Meanwhile, Zillow continues to use non-GAAP figures, which flatter the picture and should be viewed skeptically. The non-GAAP numbers often exclude items that are standard business costs. Zillow's adjusted earnings before interest, taxes, depreciation, and amortization were $87.6 million last year, compared with $49.8 million in 2014. That excludes considerable stock compensation, restructuring costs, and acquisition costs, among others.

By comparison, Zillow's GAAP loss widened to $148.9 million, or 88 cents per share, from $43.6 million, or 36 cents per share, in 2014. Even non-GAAP EPS fell, to seven cents from 12 cents in 2014. Consensus analyst adjusted EPS estimates for 2016 continue to decline. They are now nine cents, down from 19 cents 12 months ago, meaning Zillow's stock trades at a price/earnings ratio of 258 times. With revenue growth having slowed—it was just 7% in the fourth quarter, pro forma—and profits elusive, a triple-digit P/E makes the stock disproportionately vulnerable to bad news.

Zillow responds that it “continues to grow impressively, even on a large base.” According to comScore. Zillow January traffic hit a record high in unique users, up by 33% year on year, versus www.realtor.com, up 26%. Zillow is “forgoing profitability in the near term to achieve long-term growth that will lead to outsize profit potential,” the company spokeswoman says.

David Trainer asks: “If Zillow can’t make a net profit with 70% market share, when will they? How much more scale do they need?” Zillow has been around since 2004, so we wonder the same thing.

(See Trader Extra: In Search of Yield)

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