12 September 2014

Deal Terms

1 WTF = A$3.06 cash + A$0.24 dividend

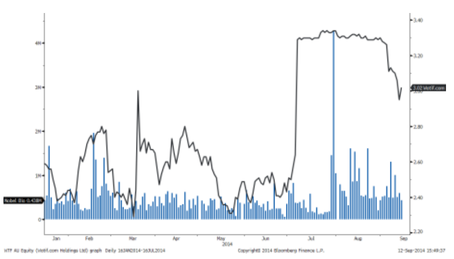
Target: Wotif.com Holdings

Country	Australia
Bloomberg	WTF AU
Sector	Online travel service
Share price (A$)	3.02
Market cap (A$m)	639.4
Free float (%)	~39.3

Acquirer: Expedia Inc.

Country	U.S.
Bloomberg	EXPE US
Sector	Online travel service
Share price (US$)	86.92
Market cap (US$m)	11,055.2
Free float (%)	~86.2

WTF AU Price Chart



Status

Merger Announced: 07 July 2014

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Wotif.com (WTF AU) / Expedia Inc (EXPE US)

Antitrust analysis

On 07 July 2014, Wotif.com (WTF) entered into a Scheme Implementation Agreement with Expedia Group (EXPE).

- On 4 September, ACCC released Statement of Issues outlining its concerns:
  - ACCC investigates whether the removal of WTF from the Australian market has the potential to increase the rate of commissions charged to hotels.
  - One could argue that the merger would harm a position of hotels.

We believe that WTF and EXPE operate two-sided platforms.
We argue that in a two-sided market, market dominance is not defined by market share but rather by market position.

- A combined entity will have a higher market share; however, we argue that a higher market share does not put the combined entity (acting as a market leader) into stronger market position.
- We believe that platforms need to maintain a sufficiently broad network on both sides in order to generate demand on the other side of the platform.
  - Based on the existence of indirect network effect in two-sided markets and the capacity of accommodation providers to discriminate among the platforms, we believe that accommodation providers will be in a favourable bargaining position even after the merger.
- A merged network may give rise to an intrinsically more valuable product which would benefit both visitors and accommodation providers as they could reach a larger database on the other side of the platform.

In some previous cases, the competition authority fails to take into account the two-sidedness of the market under consideration and the authority uses one-sided approach to the market under investigation.

- WTF/EXPE merger would create a market of total HHI equal to 2,200.
- Δ HHI after the merger is around 700.

If ACCC fails to consider WTF's market as two-sided, many of the arguments that we have used in our previous reasoning are invalid.

- Market dominance and market share are correlated in one-sided market, as opposed to two-sided market, where we argued that market dominance is not defined by market share, but rather by market position.
- In case of one-sided market, we also fail to argue that the existence of indirect network effects leaves the accommodation providers in a favourable bargaining position even after the merger.
- HHI numbers denote a moderately concentrated market; Δ HHI of 700 shows a significant change in market concentration which could raise concerns of ACCC.
  - As mitigating factors, we see a potential for innovative companies to enter the market with a new business model disrupting the position of OTAs.
  - WTF market share in online accommodation is falling; ANZ hotel room nights declined in 2H14 by 9.4%, compared to a 5.6% decline in 1H14.

In case ACCC fails to consider WTF's market as two-sided, we see considerable risks of ACCC raising concerns against the merger.

In case of ACCC's concerns we believe that WTF/EXPE could be requested to offer behavioural remedies.

- We can envisage that WTF/EXPE would be requested to offer a remedy in a form of flexible prices for hotels when they offer accommodation via their own direct channels.
  - OTAs often require pricing and volume parity from hotels.
- Possibly, the co. could be requested to fix for a specific period of time commissions charged to hotels.

We do not consider likely that EXPE would accept such remedies. Moreover, we believe that such remedies are difficult to enforce.

Based on current share prices of WTF/EXPE, we estimate the implied probability of the deal closing to be 74.3%. Following our antitrust analysis, we believe the probability of the deal closing is higher.

Current market situation in Australia

On 07 July 2014, WTF entered into a Scheme Implementation Agreement with Expedia Group under which it is proposed that Expedia will acquire 100% of the fully-diluted capital in Wotif Group by way of Scheme of Arrangement.

Wotif shareholders are offered total cash consideration of A$3.30 per share comprising of:

- A$3.06 cash per share
- A$0.24 special dividend paid by WTF on or before the Scheme Implementation Date.

On 04 September, ACCC released Statement of Issues outlining its concerns in regards to the proposed acquisition of WTF by EXPE. *ACCC is exploring whether the removal of WTF from the Australian market has the potential to increase the rate of commissions charged to hotels and other accommodation providers in Australia.* ACCC appears concerned that:

- Removal of WTF as a standalone company will allow Expedia to increase the rate of commission charged to hotels.
  - ACCC makes the point that commission rates charged by EXPE and Booking.com are lower in Australia than the rates charged by those companies in the other parts of the world.
    - The presence of WTF may be a contributing factor to this difference.
    - ACCC acknowledges the potential for companies to enter the market with new business models and to disrupt the competitive environment. Smaller OTAs such as Hooroo might suggest that barriers to entry and expansion are not significant.
      - Market participants have identified barriers mostly in the form of high costs of advertising necessary to capture the critical mass and sunk costs associated with the development of an online platform. It might be too onerous for a new OTA to obtain a sufficient number of accommodation providers.

ACCC' preliminary view is that it is appropriate to define a market based around the distribution of accommodation products.

- The activities of Expedia and WTF overlap in the areas of online booking services for accommodation, flights, holiday packages, car hire, cruises and other travel products.
- Based on ACCC' statement, bricks and mortar travel agents are not direct competitors nor substitutable for hotel and accommodation providers.
  - Based on ACCC' preliminary view, bricks and mortar agents are unlikely to be a strong constraint on the operations of online travel agents (OTAs) and therefore do not form part of the relevant market.
    - We note that in a 2010 ruling on the merger between Jetset Travelworld and Stella Travel Services, the ACCC had considered online travel agents and retail agents as part of the same market rather than a standalone channel.
    - Euromonitor estimates off-line distribution still accounts for over 64 per cent of hotel rooms booked in Australia.

One might consider that increased charges to accommodation providers from OTAs could lead to hotels enhancing booking engines on their websites, as many people logged also onto the individual hotel site before completing a booking with an OTA.

- However, Accommodation Association of Australia chief executive Richard Munro said hotels were often unable to do so by offering discounts because many OTAs required pricing and volume parity for accommodation which restricted the capacity for operators to provide lower rates through a direct booking option.
  - Simultaneously, ACCC raised concerns that accommodation providers are not being able to compete at this level given the high costs of advertising online.

OTAs generally charge a base rate of commission to accommodation providers, as well as a higher rate on top of that for accommodation providers that want to appear higher in the ranking on the search result page.

- WTF is an exception to this, as it lists hotels alphabetically by star rating in its search results.
- Accommodation providers receive approximately 20 to 50% of their bookings via OTAs; smaller providers are generally having higher booking numbers via OTAs.

ACCC is seeking further information to determine whether the proposed acquisition is likely to substantially lessen competition in the market for the online distribution of Australian accommodation. ACCC expects its final decision to be made on 02 October 2014.

Wotif.com

Wotif.com is a leading travel website selling accommodation, flights and packages online in more than 69 countries. Every month the site attracts 6.1 million visits, with customers making over 260,000 bookings.

- Wotif.com launched flights in February 2010 and offers a wide range of Australian domestic airlines, Trans-Tasman and international flights.

- Wotif.com added its holiday rentals platform in May 2012 and in May 2013 unveiled its travel packages. The standalone travel packages allow customers to book the best event tickets, hotels and flight deal in one convenient booking.

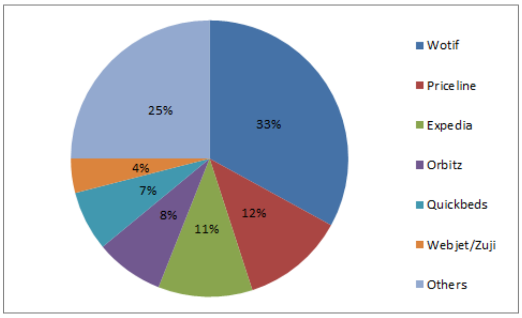
WTF's pre-announced FY14 results highlight accelerating market share loss and earnings deterioration driven by competition from aggressive OTAs.

- ANZ hotel room nights declined further in 2H14 (-9.4%, compared to -6.5% in 1H14), raising concerns about the medium-term outlook for WTF. This trend is to continue into FY15 with the competitive environment showing no signs of abating.
  - Consequently, it can be expected that the co. will increase marketing costs again in FY15, impacting margins.
  - A 3% FY14 revenue growth can be attributed to hotel commission increases and growth in the flights segment.

WTF chief executive Scott Blume last month said his company would face a "hard slog" in stemming the decline if the Expedia deal did not proceed.

- One market observer suggested that without the EXPE bid, the shares would plunge to less than $2 each.

Key players of Australia's online accommodation market (based on number of booking)



Source: IGR, companies

Potential new market participants

Tripadvisor – The co. is transforming their business model from review website to an intermediary.
Google' Hotel Finder – The search engine displays hotel listing atop search results pages and then provides an online travel agency placement as a practical booking link.
Airbnb – The co. provides a trusted community marketplace to list, discover and book accommodation around the world. Service offers an apartment for a night, a castle for a week, or a villa for a month. Airbnb connect people searching for accommodation; service is currently present in more than 34,000 cities worldwide. There are currently more websites which offer similar services.

- Airbnb has been testing a new service that goes beyond its rental platform. The new service offers guests offline "experiences," which include walking tours, bike tours, nature hikes, drink tasting, etc.

Stayz presents a way for property owners to list and promote their holiday homes online. Since 2002, Stayz has grown to become the number one holiday rental site in Australia.

Services such as Airbnb, Stayz usually do not include into their databases hotels; mostly they act as a marketplace to connect people searching/offering private accommodation. We believe that such online services are substitutes to OTAs and therefore they should be considered as part of the relevant market.

Based on the examples of Google's Hotelfinder, Airbnb, Stayz and others, we believe that there is a potential for innovative market participants in online accommodation services. We believe that there is a potential for such companies to enter the market with a new business model and to disrupt the position of OTAs.

The ACCC is viewing the relevant market as the distribution/booking of Australian accommodation, including bookings made by Australian residents and inbound booking made by offshore residents, as opposed to the whole global market.

Two-sided markets

We define WTF as platform acting in a two-sided market:

- A market in which a firm sells two distinct products or services to two different groups or consumers, while recognising that the demand from one group of consumers depends on the demand from the other group and vice versa.
  - Demand on the two sides of the market is linked by indirect network effects, and the firm recognises the existence of these indirect network effects.
  - The buyers of the two products instead, do not internalise these effects which are therefore to this regard called externalities.
    - Positive externalities occur when the value obtained by one group of consumers increases with the number of consumer of the other group.

- A firm in a two-sided market acts as a platform and tries to get both sides on board. Indeed, it needs both sides to do business.

In principle, a firm in a two-sided market sets a price for the two products it sells on each side; it might well be the case that on one of the two sides, the product is given away for free.

- Literature shows that in a two-sided market, firm's profit, consumer welfare and total welfare are determined by both the general price level and the price structure (the ratio of the prices paid by the two sides).

Literature identifies three main types of two-sided market:

- **Market-makers:** These two-sided markets enable groups to transact with each other. Examples include shopping malls, eBay, etc.
- **Audience-makers:** Audience makers match advertisers to audience. This is the case, for instance, of newspapers, television, Google, etc.
- **Demand-coordinators**: Demand-coordinators are two-sided platforms which provide goods or services that provide goods or services that generate indirect network services across two or more groups. Examples include software platforms such as Windows and payment cards.

In terms of application of competition policy there is distinction between two-sided markets of the "media type" and two-sided markets of the "payment card type".

- The markets of the "media type" are characterised by the absence of a transaction between the two sides of the market and, even though an interaction is present, it is usually not observable, so that a per-transaction or per-interaction fee is not possible.
  - Literature often refers to two-sided markets of the "media type" as **two-sided non-transaction markets**.
- In case of the markets of the "payment card type", they are characterised by the presence and observability of a transaction among the two groups of platform users.
  - They are referred as **two-sided transaction markets**.

Pricing

One observes that in many two-sided markets one of the two sides does not pay for the product or service. One can decompose the choice of prices by a two-sided platform in two stages:

- The platform first chooses the profit maximization level, and then it chooses the price structure that maximises volume given the chosen price level.
  - Profit maximization price structure depends on the ratio of elasticities. The side which has the higher elasticity of transactions with respect to price is charged more, as in a traditional single-sided market. This effect is due to the presence of the indirect network externalities.
    - In addition to the network effects, among the factors which effect the pricing decision of two-sided platforms are the presence of single-homing and multi-homing, the presence of marquee customers and that of captive customers.
    - Single-home customers choose only one platform, while customers choosing more than one platforms are said to be multi-home. Prices on the multi-homing side will be higher as the single-homing side benefits less from the presence of a higher number of customers on the multi-homing side.
    - Literature shows that "the presence of marquee buyers" (buyers generating a high surplus on the seller side) raises the seller price and lowers the buyer price, while the presence of captive buyers (buyers who will surely join the platform) tilt the price structure to the benefit of sellers.

When a transaction or interaction takes place between end users and is observable, platforms may adopt different pricing schemes, such as a flat price, a per-transaction price or a mixture of both.

Pricing decisions of platforms may be quite different from those of firms in one-sided markets. This is due to the fact that profit-maximising platforms will take into account indirect network effects between demands on the two sides of the market.

Concentration in two-sided markets

Evans and Schmalensee (2007) explain that five fundamental factors have a bearing on the size of two-sided platforms and on market structure. They explain that indirect network effects and economies of scale are likely to lead to large platforms and a concentrated market, while congestion, platform differentiation and multi-homing have the opposite effect on platform size and market concentration.

- **Indirect network effects** between the different sides promote larger and fewer platforms. In this respect, *the first movers have a significant advantage and other two-sided platforms can compete with this advantage only if they manage to offer consumers on all sides something that offsets the first mover's advantage*.

  - In a market with network externalities, it is difficult for several producers to coexist profitably and a firm with even a small edge over its rivals stands a good chance to take the entire market.
- **Economies of scale:** most two-sided platforms incur significant fixed costs and low marginal costs, the consequence of which is that these platforms benefit from economies of scale.
- **Congestion:** At a given size, expanding the number of customers on a platform may lead to congestion (for example, increasing the amount of advertising can have negative effect on readers).
  - In case of WTF, we do not see a possible issue of congestion. We believe that the increasing number of participating accommodation benefits visitors.
- **Platform differentiation:** Platforms can and do differentiate themselves by choosing particular levels of quality, particular features or prices.
- **Multi-homing:** Differentiation may lead to a situation where customers use several platforms.

By definition, a first mover in a two-sided market has a significantly stronger position than a first mover in a single-sided market, ceteris paribus; this advantage is based mostly on indirect network effects. A firm with even a small edge over its rivals stands in a strong position over its market rivals.

In our case, WTF has currently a 33% market (pre-merger) position, Priceline 12%, Expedia 11% and other OTAs the rest. In a post-merger market situation, Expedia and WTF would have cumulatively a 44% market share, Priceline 12% and other OTAs the rest.

- **We argue that in a two-sided market, a leader has a strong market position by market structure (a firm even with a small edge over its rivals stands in a strong position over its market rivals), and a market share of the leader has a significantly lower impact on the market position of the leader, as opposed to the single-sided market.**
  - **Therefore, we believe that a change in the market share of the leader will not have such a significant impact on the leader's market position compared to one-sided market.**
  - **A market position of a leader in terms of market competition will not significantly change.**
  - **Market dominance is not defined by market share but rather by market position.**

Barriers to entry

Previously we have expressed that first movers have an enormous advantage and other two-sided platforms can compete with this advantage only if they manage to offer consumers on all sides something that offsets the first mover's advantage.

- Market participants have identified barriers mostly in the form of high costs of advertising necessary to capture the critical mass and sunk costs associated with the development of an online platform It might be too onerous for a new OTA to obtain a sufficient number of accommodation providers.
- In connection to it, another potential barrier to entry is a coordination problem that results from the interdependency of different sides of a platform and the existence of indirect network effects.

According to the literature, there are reasons to believe that entry barriers are higher in two-sided markets, but it needs not always to be the case.

Mergers in two-sided markets

Precedential cases

The Truvo Nederland/European Directories (2008) decision is a milestone in the sense that it recognises that, in a two-sided market, a larger network may give rise to an intrinsically more valuable product and that, where it is the case, it must be counted as a factor in favour of a transaction.

- The Truvo Nederland/European Directories case concerned a merger between the only two print directories in the Netherlands.
- NMa (Nederlandse Mededingingsautoriteit, Netherlands Competition Authority) recognizes the benefits of having a larger network as a result of the merger. NMa considered that advertisers would benefit from the combination of the two Dutch directories.
  - NMa argues that so-called "overlap advertisers" are likely to benefit from the merger because they will be able to reach all directory users by advertising in a single directory.
  - With respect to "non-overlap advertisers", they are considered to benefit from an increase in usage of the combined directory.
  - Overall, NMa is acknowledging that a merger may increase the positive externalities between the various sides of the platform. Therefore NMa recognizes that the merger benefits advertisers as it leads to an increase on the other side of the platform.
  - NMa further argues that an increased price or reduced quality which would neutralise the benefits are unlikely

        - NMa argues that it is unlikely that users would be required to pay for the directory post-merger as the majority of the users of directories appear not to be ready to pay for it. A substantial diminution in the use of the directory would make the product less attractive for advertisers, which could generally affect their use.
        - Based on similar arguments, NMa does not consider a reduction in the quality of the directory as a likely scenario.

A merger of **Travelport/Worldspan** (2007) reduced the number of global distribution system (GDS) providers active in the EEA from four to three and increased significantly the merged undertaking's combined market share in a number of member states.

- At the time of merger investigation, the market shares of the GDS providers varied substantially depending on region and country concerned. Post-merger in an EEA-wide market, Amadeus would be by far the largest GDS provider in relation to travel service providers, with a market share of [50-60%], whereas Galileo/Worldspan would become the second largest operator with a market share of [20-30%]. Sabre's EEA market share would amount to [10-20%].

The Commission identified three theories of harm which it considered prima facie plausible:

- The merger would allow the merging undertakings to use their strong market position downstream vis-à-vis TAs in order to increase prices vis-à-vis TSPs upstream ("vertical cross market effects")
    - It is assumed that TSPs generally use multi-homing, as they have to distribute their content via all four GDSs in order to obtain the desired market coverage, whereas the TAs use sign-homing, as one GDS suffices in most cases to provide them with the required TSP content (multi-homing/single-homing).
    - This means that GDS providers only compete for customers on the TA side of the platform.
- The merger would eliminate Worldspan as the alleged "pricing Maverick" and therefore would lead to post-merger price increases
- The merger would allow the parties to exploit their post-merger market power vis-à-vis TAs in Member States in which Galileo/Worldspan would have high market shares.

The EC observes that travel agents have the capacity to withhold specific content and even to discriminate between GDS providers. This introduces an element of differentiation which may lead agents to switch to another GDS.

- Moreover, the Commission notes that there are alternative technological platforms which may allow airlines to bypass the GDS and directly access travel agents or even end-consumers.

European Commission held that the merger of Travelport/Worldspan is unlikely to harm travel agents as a sufficient number of GDS platforms would remain available to travel agents post-merger.

- Moreover, the Commission states that the fact that GDS providers need to create and maintain a sufficiently broad network of travel agents in order to generate demand on the travel service provider side leaves travel agents in a favourable bargaining position vis-à-vis GDS providers even after the elimination of one of them.

Our view on merger effects

One could be concerned that the merger could potentially increase the rate of commission rates charged to hotels in Australia. One could argue that this would harm providers.

- We argue that in a two-sided market, market dominance is not defined by market share but rather by market position.
    - WTF is currently a market leader and therefore the merger will not result in a new market leader. A combined entity will have a higher market share; however, we argue that a higher market share does not put the combined entity (acting as a market leader) in a stronger market position.
- We argue that platforms need to maintain a sufficiently broad network on both sides in order to generate demand on the other side of the platform.
    - Accommodation providers have the capacity to discriminate among the platforms. This introduces an element of differentiation which may lead the customers to switch to another platform.
        - Based on the existence of indirect network effect in two-sided markets and the capacity of accommodation providers to discriminate among the platforms, we believe that accommodation providers will be in a favourable bargaining position even after the merger.
- A merged network may give rise to an intrinsically more valuable product which would benefit both visitors and accommodation providers as they could reach a larger database on the other side of the platform.

ACCC does not consider two-sidedness of the market

In some of the previous cases, the competition authority fails to take into account the two-sidedness of the market under consideration and they use one-sided approach to the market under investigation.

- Two-sided markets differ from one-sided markets in terms of pricing decision-making, market position of the participants, market concentration, etc. and therefore we believe that failing to consider this case as a two-sided market could result in different outcomes.

Taking into consideration current market shares of market participants we perform a concentration analysis of online accommodation market in Australia.

- WTF/Expedia merger would create a market of total HHI equal to 2,200 (We note that we assume that the merged entity would have a combined market share of 44%).
- Δ HHI after the mergers is around 700.
- HHI numbers show a moderately concentrated market.

If ACCC fails to consider WTF's market as two-sided, many of the arguments that we have used in our previous reasoning are invalid.

- Market dominance and market share are correlated in one-sided market, as opposed to two-side market, where we argued that market dominance is not defined by market share, but rather by market position.
- In case of one-sided market, we also fail to argue that the existence of indirect network effects leaves the accommodation providers in a favourable bargaining position even after the merger.

We conclude that many of the argument that we used in our two-sided model are not valid if we consider the market of WTF as one-sided.

- Moreover, HHI numbers denote a moderately concentrated market, and Δ HHI of 700 shows a significant change in market concentration which could raise concerns of ACCC. However, we believe that there are mitigating factors to this market situation.
  - We believe that there is a potential for innovative companies to enter the market with a new business model and to disrupt the position of OTAs.
  - WTF market share in online accommodation is falling; ANZ hotel room nights declined in 2H14 by 9.4%, compared to a 5.6% decline in 1H14.
- In case ACCC fails to consider WTF's market as two-sided, we see considerable risks of ACCC raising concerns against the merger.

In case of ACCC' concerns, we believe that WTF/EXPE could be requested to offer behavioral remedies. Given general business model of OTAs, it is difficult to envisage any structural remedies that WTF/EXPE could offer.

- OTAs often require pricing and volume parity which restricts the capacity of accommodation providers to offer lower rates through direct booking.
  - We can envisage that WTF/EXPE would be requested to offer a remedy in a form of flexible prices for hotels when they offer accommodation via their own direct channels.
  - Possibly, the co. could be requested to fix for a specific period of time commissions charged to hotels.
    - We do not consider likely that EXPE would agree to this kind of remedies.
    - We believe that such remedies are difficult to enforce. The companies have a large maneuvering space to come up with different types of commission rates or they could transfer such increased prices to other parties.

Probability of deal closing

Assumptions	
Target current share price	$3.02
Bidder current share price	$96.14
Offer price	$3.30
Current spread	*-8.5%*
Date today	*12 September 2014*
Estimated downside ($/share)	$2.3
Target deal closing date	31 December 2014
Risk free rate	*3.2%*
Discount factor	*0.99*
TV offer	$3.27
Probability of close	**74.3%**
Probability of the deal breaking	**25.7%**
Gross annualized return	**30.9%**

Source: IGR, Bloomberg

Assumptions:

Deal closing date: 31 December 2014

Risk free rate: AUD 1 yr swap + 0.45%

Based on current share prices of WTF/EXPE, we estimate the implied probability of the deal closing to be 74.3%. Following our antitrust analysis, we believe the probability of the deal closing is higher.

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