June 27, 2014

Zillow (Nasdaq:Z) Gives Away Potentially Most Lucrative Market ... for FREE??

How Can You Win At Monopoly when you Give Away Boardwalk for Free?

The stock market is a funny place; sometimes you can be right and wrong at the same time. Over the past two years, Citron Research has been critical of Zillow's business model. Zillow's financial performance has repeatedly proven us right -- generating **topline and bottom line misses and downward revisions**. Yet the stock price has proven us wrong: 40 to 140 in 18 months!

Zillow, Inc. (NASDAQ:Z)

	January 1, 2013	Sept 19, 2013	% Change		June 26, 2014	% Change
Stock Price	27.75	98.27	254%		140.00	405%
2014 Consensus EPS	1.07	.57	**-46.7%**		.29	**-72.9%**
2015 Consensus EPS	1.47	1.23	**-16.3%**		.85	**-42.2%**
2016 Consensus EPS	1.87	1.53	**-18.0%**		1.41	**-24.6%**

Citron could write 100 pages on the irreconcilable structural flaws in ZIllow's business model- past, present, and future, which are directly responsible for the earnings disappointments. But the company just delivered the message on a silver platter in one simple press release:

Zillow and Douglas Elliman Real Estate Company Launch Strategic Marketing Partnership

http://online.wsj.com/article/PR-CO-20140624-909960.html

This week's release said it all. When we read about the partnership between Zillow and Douglas Elliman, the largest name in New York City real estate, a release that discloses **no financial details**, we couldn't believe our eyes. **Did Zillow just give away the keys to its most potentially lucrative market in the entire United States … for free?**

The press release says Douglas Elliman is Zillow's marketing partner. **Elliman shouldn't be Zillow's marketing partner- they should be Zillow's customer… Not just any customer, one of its largest customers!**

So much for the mythical metric "eyeballs" on Real Estate listings … or 2018 EBIDTA … or any other nonsense metric Wall Street is hooked on besides profitability. All you need to know is this:

Starting this week Zillow has just given Douglas Elliman featured listing status for its 9,000 listings, anointing its agents with the special branding opportunity normally reserved for its highest paying Real Estate Agent / customers.

With this agreement, all Elliman property listings now appear as "featured listings", displayed on top of all Zillow's search results in NY City. **The Zillow website and app will become a default advertisement for Douglas Elliman.** And specifically, with the "featured listing" designation for all those listings, they become **unavailable as inventory** for display ad sales for other brokers, thereby basically giving away the most valuable piece of inventory they own.

Further, Zillow now has completed the abandonment of the revenue stream its acquired StreetEasy.com used to generate.

Most everyone knows about Zillow's acquisition of the popular New York City website StreetEasy. When StreetEasy was acquired by Zillow they used to charge $10 a month or $100 a year for subscription for real estate search tools. In February of this year Zillow went free with StreetEasy saying "Today's move is part of a redesign that makes more space for "featured listing" advertisements purchased by developers and brokers" And than what do they do…they give away the featured listings to their potential biggest customer. No subscription fees no featured listing fees.

http://www.bloomberg.com/news/2014-02-12/zillow-drops-search-fees-for-nyc-listings-site-streeteasy.html

This is time management has to NOT: Tweet, Vine, Instagram, Facebook, or even Tinder its shareholders -- this is the time for old school disclosure. What were the financial terms behind this transaction? When a publicly traded company touts a "partnership" with no financial terms, it's almost always because they are immaterial.

Why would Zillow Do Such a Thing?

This deal completely deconstructs Zillow's business model. Zillow **ought be most dominant** in cities without a public-facing MLS system, because it provides something for which no other source exists. That's why StreetEasy could charge $10 per month or $100 per year. New York City has always been the holy grail for a real estate listing service to exploit the lack of MLS in a competitive environment with high RE prices. So what does Zillow do? It gives i it away for free.

What does this mean to the value of its offerings for Realtors in cities **with** a public facing MLS, like Los Angeles, Chicago, and Houston?

It is all about the listings.

The highlights the unique flaw in Zillow's business: its customers are also its content providers, which leaves it operating within a culture of irreconcilable conflict.

Zillow's Achilles Heel has always been that it does not own its content (the listings) -- it is utterly dependent on broker cooperation and participation in order to have accurate content **(the listings)** to display. I**n the U.S., unlike other countries, real estate listings**

are just a commodity that can be found all over – it is a fragmented market. This weakness was highlighted in a recent Forbes article that explains that listing agents have the upper hand in the relationship.

> "Listing Agencies Have the Upper Hand,"
>
> *--Panos Mourdoukoutas, Forbes*

http://www.forbes.com/sites/panosmourdoukoutas/2014/06/20/zillows-weak-spot/

> "Zillow not only offers property listings without charge but also prominently names the agent marketing the property,"
>
> *--Benjamin Edelman, Harvard Business Review*

http://www.hbs.edu/faculty/Pages/item.aspx?num=47429

Since day one, Zillow's unresolved flaw in its business model is the proposition of forcing Real Estate agents and brokers to spend their advertising dollars to get leads **from their own listings.** With this deal, Zillow irrefutably demonstrates the major headwind this problem really represents. This practice has never been fair to the consumer or the broker. **The Douglas Elliman deal demonstrates conclusively that the power of the listing outweighs the power of the web traffic.**

Without Zillow, Douglas Elliman would sell the same amount of Real Estate in New York. But without Douglas Elliman, Zillow would be irrelevant in New York.

Zillow needed to get Elliman in its listing system in order to preserve the relevance and credibility of its NYC listings. The lack of accuracy in its listings is so evident that one of its competitors, www.realtor.com, has dedicated its entire marketing message to criticize Zillow's obvious weak point: accuracy of listings. (Funny commercials)
https://www.youtube.com/watch?v=d9sRsTdOzeY
https://www.youtube.com/watch?v=PEDAT3ASKN4

Why Zillow Does Not Want Investors or Any Other Brokerage Firms to Know About the Details of the Douglas Elliman Deal

Here is some simple analysis. Let's look at 2 zip codes in New York starting with real estate hotbed SOHO -- 10013: http://www.zillow.com/homes/10013_rb/

The first thing you will notice when going to "newest" is that every Douglas Elliman listing is 4 days old, despite how long they have really been on the market. But who really cares about honesty when you are running a business? Most importantly, notice that by being anointed "featured listings", **Zillow restricts competing broker advertisements around those listings.**

Compare a Featured Listing with just one broker to a "non-featured" one, which shows multiple broker ads competing on another broker's listing:
http://www.zillow.com/homedetails/138-Mulberry-St-3A-New-York-NY-10013/2106350451_zpid/

And what would a summertime analysis be without the Hamptons? The same goes for East Hampton –

http://www.zillow.com/homes/for_sale/Suffolk-County-NY/list/2046_rid/days_sort/40.97717,-72.34218,40.843786,-72.485249_rect/6_p/

What is important here is this demonstrates the dismantling of the Zillow core business model of selling leads to brokers around other people's listings. More importantly it shows that Zillow's traffic was not enough to make Elliman want to pay any significant sums of money for this deal. The reality of this deal will impact the pricing power of Zillow going forward in major markets.

We can't stress this enough:

Without Zillow, Douglas Elliman would sell the same amount of Real Estate in New York. But without Douglas Elliman, Zillow would be irrelevant in New York.

The fallout from this partnership could be devastating.

Zillow now has passively telegraphed to all major brokerage firms in the US that if you withhold listings from Zillow, you too can get unique branding and featured listing status for your properties.

Everything about this deal hurts the perceived value of the Zillow brand to all paying/advertising realtors/customers. Principally, it highlights the disconnect between what Wall St. thinks Zillow is (a real estate behemoth) and what Zillow really is (a lead generation company that is nothing without listings).

Zillow HAD to do this deal as recently as last week as the competitive landscape is shifting under their feet

Just last week the Real Estate Board Of New York (REBNY) decided to implement Internet Data Exchange (IDX) for their listings. This is a broker-neutral platform that affords consumers easy access to view pooled listings on agent or broker websites.

REBNY Votes to Implement Internet Data Exchange (IDX) As Part of Listing Service

http://www.rebny.com/content/rebny/en/newsroom/press-releases/2014/idx_rls_vote.html

This was a direct attack on Zillow, as brokers are positioning themselves to generate traffic on their own websites.

http://www.inman.com/2014/06/20/idx-comes-to-new-york-rebny-votes-to-allow-brokers-agents-to-display-pooled-listings/

Another harbinger of change in the NY Listings market:

> Kathy Braddock, Purcell's fellow managing director at William Raveis, also cited the rise of StreetEasy, which was bought by Zillow last year for $50 million, as the key factor in REBNY's decision to adopt IDX. Allowing the general public to skip that step brings REBNY's RLS system in line with Zillow and StreetEasy, which do not require users to log in to browse listings.

http://therealdeal.com/blog/2014/06/20/rebny-to-integrate-idx-into-its-listing-service/

Brokers would rather use the new IDX system to drive traffic to their own websites.

Zillow is forced to cut as many deals for direct feeds from brokers as possible – in an attempt to preclude another Austin, Texas situation.

In October 2013 The Austin Multiple Listing Service turned off its feed of listings to syndication sites like Zillow as of April 2014. As of now, the only way Zillow gets a listing in Austin is if the broker opts to upload it themselves.

http://www.inman.com/2013/10/30/8-more-austin-real-estate-brokerages-turn-off-flow-of-listings-to-portals/

As of the date of this report there are currently 10,100 properties displayed for sale on the official MLS of Austin:
http://www.austinhomesearch.com/Listing/ListingSearch.aspx

Yet, if you go to Zillow and search Austin, Texas you only see results for 2,568 properties: http://www.zillow.com/homes/ That's scarcely **25%** of the listings in Austin!

Pricing Power? Look Down Under

The rationale behind Zillow's recent price strength in the stock is partially due to management's having convinced analysts that they are gaining increasing "pricing power" -- the ability to raise advertising rates in the near future.

The empty rhetoric of this promise is laid bare by the Douglas Elliman deal. Wall Street will soon realize that the consumer regards Real Estate listings as a commodity, like a stock quote. Having spent hundreds of millions on wave after wave of consumer advertising, Zillow still only controls 17% of the real estate traffic in the US and is far from being a controlling force.

Investors must consider Australia and the recent 20% pullback in the REA group. Real Estate agents in Australia have pushed back against price increases on a site that controls 67% of the real estate traffic there and have gone as far as launching a broker owned portal of their own.

Broker-owned portal to launch in Australia

http://www.inman.com/wire/broker-owned-portal-to-launch-in-australia/?utm_source=20140625&utm_medium=email&utm_campaign=dailyheadlinesam#.U61vHfldUwD

It is Citron's firmly held opinion that broker indifference to Zillow as a lead-generation tool, plus what we are seeing in New York and other markets worldwide is the "tell" of a coming correction in Zillow's vulnerable business model.

These links are must-read if you invest in this space. If anyone thought the U.S Real Estate market was going to become a model like Australia's, now we see that Australia is more likely to become the U.S. when it comes to brokers taking control of their own listings!

http://www.rebonline.com.au/breaking-news/7759-industry-mounts-comeback-against-rea-group
http://www.fool.com.au/2014/06/25/is-this-the-beginning-of-the-end-for-rea-group-limited/?source=aptyholnk3030003

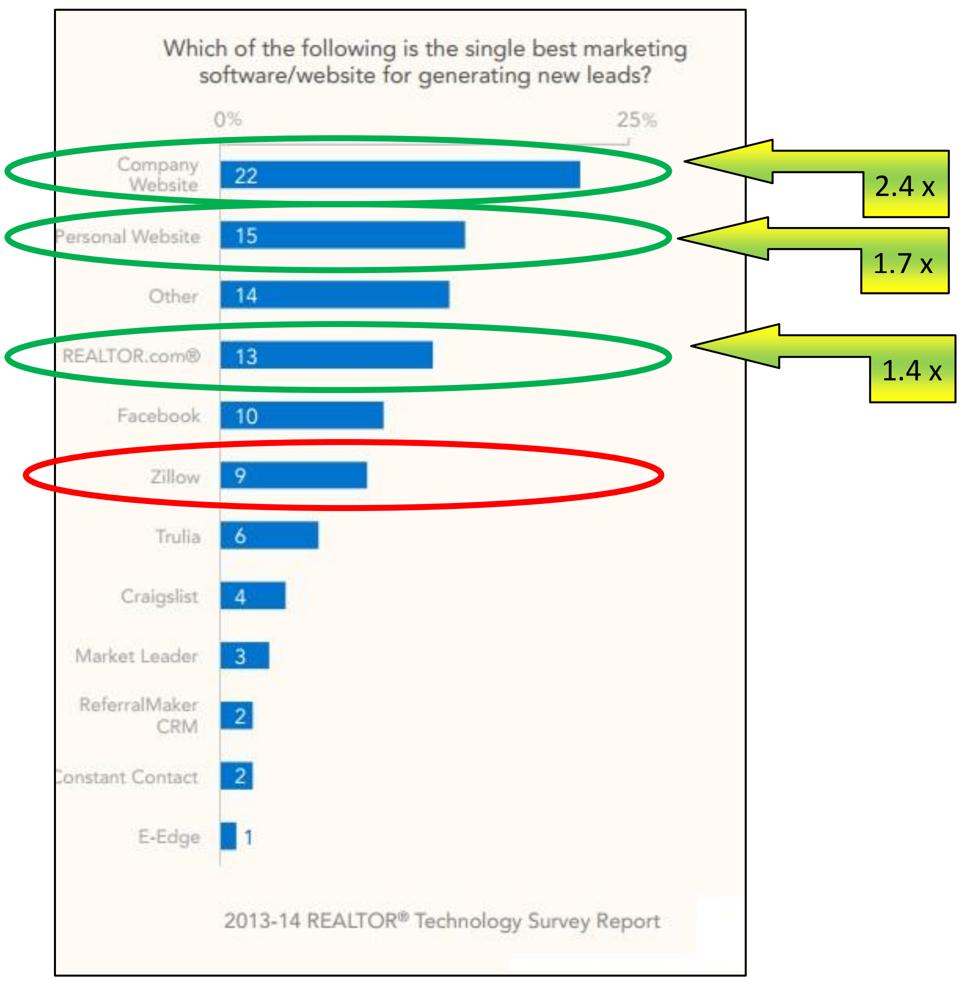
Any recent news on how brokers feel about Zillow? Is it a "Must Have"?

JUST THIS WEEK Inman news reported the results of survey responses from nearly 1,300 randomly selected real estate agents … and it was not at all favorable to Zillow.

When asked to pick the single best marketing software or website to generate new leads, 22 percent cited their company website, followed by their personal website (15 percent), "other" (14 percent), realtor.com (13 percent), Facebook (10 percent), **Zillow (9 percent)** and Trulia (6 percent).

http://www.inman.com/2014/06/25/realtors-want-more-technology-from-brokers-and-mlss/

Here is the study result as published. Again, this report was issued **just this week**:



http://crt.blogs.realtor.org/2014/06/24/crt-technology-survey-for-2013-2014/files/2014/06/2013-14-CRT-Tech-Survey.pdf

This survey clearly demonstrates non-differentiation of product, with even Realtor.com (with a market cap 1/10th of Zillow's) preferred by a 3:2 margin. More importantly it shows the importance of individual websites: real estate, unlike travel, has always been, and will always be, a people business.

Conclusion

At the beginning of 2013, you could invest in Zillow at $28, for a share for a company that was supposed to generate **$65 mil in EBIDTA** in 2014.

Today you are paying **$140** a share for what analysts now project to be **$50 mil in EBIDTA. All this for a company that does not really know what it is and whose business model is constantly under attack not only from its competition -- but from its own customers.**

For this, investors are paying 20x revenues and a 142 P/E on forward earnings? Good luck with that!

Caveat emptor.

Cautious Investing to All

* Spencer Rascoff

In past writings, Citron has been critical of Zillow CEO Spence Rascoff. We've gone as far as to lampoon him on the site – and for this we apologize. If we were starting a public company tomorrow we would hire a top notch COO and make Rascoff the CEO. It is impossible to look at the stock chart of Zillow and not attribute it to the tireless interviews, tweets, and social media enthusiasm that Rascoff exudes every time he opens his mouth.

Considering the company has consistently missed bottom line estimates for three years, we give him a C- as an operator. Because Wall Street doesn't care, and instead has been mesmerized by Rascoff's enthusiastic misdirection of focus toward "eyeballs" and away from a profitable business model, we give him an A+; he's a true master of the Jedi Mind Trick.