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This Means War!
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When actor William Shatner signed on as the spokesman for Priceline.com in 1997, he made a decision that could have made him very rich: He agreed to take part of his compensation in stock. After the company's initial public offering two years later, shares of the online travel agency took off, zooming 331% the first day. Unfortunately, Star Trek's Captain Kirk says he panicked at the controls, selling his shares after the stock crashed back to earth.

A lot of other investors have made fortunes in Priceline (ticker: PCLN), however. The online travel company is the best-performing stock in the Standard & Poor's 500 over the past five years, rising 519%. Since hitting a low in 2003, the shares are up more than 100-fold. But big gains will be harder to come by from here. Increased competition for travelers' dollars is likely to squeeze profit margins for all of the big online travel agencies, including Expedia (EXPE), Orbitz Worldwide (OWW), and privately held Travelocity. And expansion into Asia and Latin America, which are viewed as the next big opportunities, is riskier and less profitable than it was in the U.S. and Europe.

Taken altogether, Priceline's annual profit increases could fall from 20-plus percent now, to the mid-teens. So far this year, shares are up 20%, and now trade at 19 times estimated 2013 earnings. But if earnings growth decelerates, the stock could slip 20% or more.

That's not to say that Priceline isn't a very well-managed company. With $6.5 billion in revenue forecast for this year and a market value of $37.1 billion, Priceline is the industry's largest and most profitable player.

Expedia claims the crown in total bookings $34 billion to Priceline's $28 billion. But Priceline gets a larger share of hotel bookings, especially in Europe, which are more lucrative than airline and rental-car bookings.

Online travel agencies now comprise 11% of the $1.2 trillion in worldwide bookings, according to PhoCusWright, a travel research firm. Commissions run as low as 2% for airline tickets, to as much as 30% for some hotels. And the online market is growing at a rapid clip.

But competition is increasing, as well and not just from rival online travel sites. Search engines, particularly Google (GOOG), are raking in more off the top for steering consumers to online travel agencies. Three years ago, for example, if people Googled "Hotels in Paris," they were presented with a traditional search page, consisting of free links directing them to online travel agencies and hotel operators, along with paid ads along the side.

Google "Hotels in Paris" today, and a box pops up showcasing prices and directing readers to a sophisticated map, complete with pictures, ratings, and other data. Online travel firms pay the search firm for a "booking button" that allows travelers to book a room.

The technology aims to turn browsers into bookers, says Andrew Silverman, product manager of Google's Hotel Finder. But at a price, Expedia CFO Mark Okerstrom told Barron's. "Generally, the higher the quality of the lead, the higher the cost-per-click."

Indeed, Priceline's spending on online marketing, including those booking buttons, has more than tripled in the past three years, rising to nearly $1.3 billion in 2012.

Then there are the meta-search companies, such as Kayak Software (KYAK) and Hipmunk. These companies aggregate hotel and flight listings from numerous Web sources, including online agencies, airlines, and hotel firms. While these firms are small now, they clearly represent a threat. Last year Priceline agreed to pay $1.8 billion, or five times expected 2013 revenue, to acquire Kayak; the deal is awaiting approval by European regulators.

If Priceline is vulnerable, its competitors could be even more vulnerable. Priceline is expected to earn $1.8 billion, or $38.77 a share, in 2013. And it produces enormous free cash flow an estimated $1.98 billion this year, or more than twice as much as Expedia and Orbitz combined. At the end of 2012, it had $3.8 billion of net cash and short-term investments.

Travelocity does not report its financial information.

That being said, Priceline's most lucrative market European hotels, where it has at least 10% of the market is under attack from Expedia.

Airlines, hotels, and rental-car companies have always had an uneasy relationship with travel agencies. They don't want to pay too much to the middlemen, but they need them to fill seats and rooms. That's one reason why Sabre Holdings, then a part of American Airlines parent company AMR Group, launched Travelocity in 1996. Sabre had helped lead the march to aggregate flight information and distribute it electronically to travel agents the old-fashioned kind in the 1960s.

Microsoft launched Expedia as an in-house project in 1996, taking it public three years later. Expedia's properties include Hotels.com, HotWire.com, and Expedia.com. This year analysts expect it to earn $465 million, or $3.47 a share, on revenue of $4.7 billion.

Orbitz, the smallest of the publicly traded online agencies, was launched in 2001 by a consortium of five major airlines, including United, Northwest, and Delta. Its brands include CheapTickets, ebookers, and Hotel Club. But because of its core concentration in low-margin air travel, it has lost money for years. Orbitz is expected to finally turn profitable this year, earning $32 million, or 29 cents a share, on revenue of $812 million.

Priceline, by contrast, was launched by serial entrepreneur Jay Walker in 1997, with a unique system that allowed consumers to make lowball bids on rooms. The catch to the company's "Name Your Own Price" system was that travelers didn't learn the identity of the

airline or the hotel until after the booking had been made. The Norwalk, Conn.-based company came public in March 1999 at $96 a share, adjusted for a one-for-six reverse split in 2003, and jumped to $414 by the end of the day.

Its business model quickly ran into a series of buzz saws. An attempt to use the same technology to let consumers name their own price for groceries and gas failed, the Internet bubble burst, and the airline business became more competitive and less lucrative after the 9/11 terrorist attacks led airlines to sharply curtail flights.

But unlike so many boom-and-bust Internet companies of the era, Priceline had a second act. In 2002, Jeffery Boyd, Priceline's chief operating officer, took over as CEO and quickly shifted the company's focus to hotels, which typically pay commissions of 15% to 25%. Rental cars pay closer to 8%, and airlines just 2% to 3%. He also decided to expand beyond Name Your Own Price to offer travel listings at disclosed rates, and expand to Europe.

In Europe, low-cost carriers were proliferating in the mid-2000s, and cheap fares helped persuade Europeans to travel more. While there were online firms in various countries, no one had created a comprehensive database of listings throughout the continent.

Other factors made Europe particularly attractive: About three-quarters of U.S. hotels are part of chains, meaning they have ample budgets to market themselves to the public. But the ratio was reversed in Europe, with about three-quarters owned by independent operators. Those hotels couldn't afford to advertise widely and came to rely on the online firms to fill their rooms.

Priceline bought Amsterdam-based Booking.com in 2005, which turned out to be exactly the right move at exactly the right time. With a fragmented market and changing travel patterns, a slew of customers turned to the Internet to find travel ideas. Booking.com has created a database with more than 200,000 hotels. Since 2005 the company's gross profit effectively the commissions it earns has grown by 15 times, to $4.1 billion in 2012.

While American consumers know Priceline best for its namesake brand, thanks in part to William Shatner's goofy commercials, the company's most recognized brand worldwide and its biggest profit engine is Booking.com. At least 60% of Priceline's booked room nights are in Europe, Priceline disclosed in a conference call last year. The company has also expanded aggressively into Asia with the purchase of Agoda.com in 2007 and by forming partnerships with other travel sites. Last year, 92% of its operating income was generated overseas.

That has not gone unnoticed by competitors. Orbitz and Travelocity are now putting more focus on the most profitable segment in the travel market international hotels and ramping up their online ad campaigns.

And in the past five years, meta-search companies, like Kayak and Hipmunk, and trivago in Europe, have aggregated the data from the big online firms, as well as airlines, and presented an even broader array of travel options to consumers in an easy-to-compare format. The meta-search companies then take a cut of the cut of the commission when customers make a booking.

Other intermediaries take their own piece of the action. TripAdvisor (TRIP) offers literally millions of hotel reviews and acts as a search engine for flights and hotel rooms. To the consumer, it's extremely difficult to tell the difference between review sites that direct people to book elsewhere (and take a cut), meta-search sites, and the online travel agencies themselves. All the buyer knows is that he's paying $500 for a two-night stay at a hotel in Brussels through Kayak.com. But after his credit card is processed, Hotels.com may take about $100, and Kayak about $30.

Recognizing the threat, Expedia bought a controlling stake in European company trivago, and Priceline agreed to buy Kayak. Meta-search firms tend to be less profitable than online travel agencies, because the provider gets paid per click instead of receiving a flat booking fee. Booking.com, for example, takes about 15% of each hotel transaction, while a meta-search company receives only about 7%. Kayak's operating profit margin was 14% last year, versus 35% for Priceline. The acquisitions may expand the companies' reach, but at the expense of profitability.

The big players are also encroaching on each other's turf. Priceline is fighting to gain share in the U.S., where its name-your-own-price deals have lost ground to Expedia. Priceline launched a new television ad campaign for Booking.com this year in the U.S., hoping to eat away at Expedia's lead. "There's a lot of money being spent, but it's a zero-sum game" in the U.S., says Hipmunk co-founder Adam Goldstein.

Expedia, meanwhile, has gotten much more aggressive in Europe, revamping its technology and negotiating new deals with European hotel suppliers to draw more hotel clients and customers. "Europe is a huge opportunity for us," says Expedia's Okerstrom, noting that the company is gaining market share there. The total European bookings market, he adds, is over $300 billion.

Hotels and airline companies are fighting back too. "Occupancy in the hotel industry is not going up in line with online travel agent growth, so that means that we are paying more for business we would have gotten from a different method in the past," said Gareth Gaston, who runs e-commerce for Wyndham Worldwide. Six major hotel chains even launched their own booking site, called RoomKey.com, to draw travelers back to their sites. PhoCusWright sees suppliers taking back share from OTAs in the U.S. for the next few years.

The online companies see more opportunity in Asia and Latin America. The U.S. and Europe account for about two-thirds of the global travel, but Asia and Latin America are "the next pot of gold," according to a PhoCusWright report. The online travel agencies have boosted their presence in markets like China and Brazil, advertising their Western brands and partnering with local operators. The size and growth rates of these markets are unclear, because the companies don't break out results by region internationally.

Competition in emerging markets has gotten particularly fierce. In China, considered the hottest market in Asia, Priceline and Expedia partner with or own local operators. But Baidu, China's giant search firm, has also moved aggressively into the travel market with its own meta-search company. In the past year or so, the Chinese market has seen a dramatic increase in competition for market share. A couponing war has erupted between the major players, who are offering customers sizable refunds to book with them.

"It's getting worse and worse," says ABR Investment Strategy analyst Henry Guo. "In some cases they don't have any margin left. It's not a good way to compete."

In general, emerging markets present a large long-term opportunity, but they are likely to grow in fits and starts, and it's not clear that the multinational players will dominate local operators. "Europe was able to grow so lightning fast because there was a very established market for travel," says Carroll Rheem, senior director of research at PhoCusWright. "The thing about new travelers is that they need a lot more hand-holding, and online is typically a self-service product. I don't think they'll move as quickly in those marketplaces because of that."

There are only a handful of analysts on Wall Street who see Priceline or Expedia running into headwinds the average price target for both stocks is more than 10% above current prices. Priceline in particular has shown it can evolve as the fast-moving travel industry changes, and its substantial free cash flow means it can afford to pay up in an ad war.

Wall Street's sanguine expectations mean that the disappointment could be severe if margins slip. With the U.S. market fully saturated and Europe approaching saturation, emerging markets will likely account for the bulk of growth at the online travel firms. There's considerable opportunity there, but local competitors and lower room rates will weigh on results.

Expedia is already feeling the pinch as it expands internationally. In the most recent quarter, its revenue per room night fell 6%. And on the company's most recent conference call, Priceline's Boyd said he was willing to make a tradeoff on margins if it means the company can keep adding more beds to its inventory.

Last year, Priceline's gross profit growth slowed to 33% from 61% in 2011, while ad spending rose by 37%, after a 62% jump in 2011. If gross profits grow 25% this year, and ad spending ramps up 40%, the company's earnings growth rate could slow to the mid-teens.

At that rate, investors might not be willing to pay 19 times earnings for the shares. At 16 times, the stock would be worth under $600. And if investors overreact as they did with another former market darling, Apple the stock could go even lower.

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