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“We built this company on pay per performance to begin with and its no secret that we did it with Google. Google and us have had a very good relationship together. We’ve both benefited tremendously.” -Glenn Fogel, CEO of Booking

Google is the gatekeeper to the internet. Once upon a time we had web “portals” that served as the “home page” where internet users started any exploration of the internet. But today it’s just Google. Whether you go to Google.com or type a search term into the URL bar of your desktop or smartphone browser, you are accessing the internet through Google.

We are a long-time shareholder of Google and have [stated](#) before that the company’s services “have become a required part of modern life, almost a form of oxygen for internet connected populations,” as well as [claimed](#) that “Google’s opening up of the collective knowledge of humanity to anyone with an internet connected device at no cost to the user can easily be seen as one of the most important social benefits ever created by any nonprofit or for-profit organization.”

But a lot of people just think of Google as a monster that devours profits that have historically accrued to other companies.

Devouring other companies’ profits is not a bad thing. It is how capitalism is supposed to work. But if you are one of the companies whose profits are being devoured, you’ll take no comfort in this philosophical view. As Google shareholders, we are well aware of the company’s extremely powerful position and its ability to change the fortunes of other companies at a whim.

So it may seem irrational that one of our largest holdings is Booking Holdings, the leading online travel company operating in a space where Google has recently thrown its weight around. But while we agree that Google will continue to capture the largest portion of the online travel profit stream and grow their share, we think Booking is uniquely advantage within the publicly traded online travel peer group as being well positioned to dodge this threat.

Booking Holdings is an online travel agency (OTA). This means that it actually books travel related reservations. Expedia is the other big player in this space. The other main type of online travel company offers “metasearch.” Metasearch websites like Kayak or TripAdvisor are designed to search across multiple travel related sites to find the best deal and then earn ad revenue for sending users to those other sites to then book a reservation.

Both types of companies provide a type of service known as “vertical search,” which searches the internet, but within a limited domain of information. Vertical search services are not limited to traditional search engines. Amazon can be thought of as vertical search

for shopping. More product searches start on Amazon than start at Google. While Google's general search offering is outstanding, some categories of information can benefit from specialized search services. In certain niches, vertical search services from companies such as Yelp, Zillow, and LexisNexis have thrived despite Google's dominance in general search.

But the thing about the travel-related vertical search industry is that it is big, big business. According to [research](#) by Skift, one of the leading travel industry research groups, Google's travel related advertisements generate so much revenue that this one segment of Google business is more valuable than any of the standalone online travel companies. It is generally thought that Booking may well be Google's single-biggest customer and that travel overall is one of Google's biggest sources of advertising revenue.

But that's not enough for Google. Like any good competitor, they aren't happy being first. They want to win and win, and then win some more. They don't just want to generate the most profits in the industry, they want to maximize profits, period.

One strategy Google has deployed to win a larger share of the travel industry profit pool is create their own vertical search products. Back in 2011, the company launched [Google Flights](#), and today this search product is considered the gold standard for the vertical search category for finding airline tickets. Unlike general Google search, which returns a list of links to other websites, Google Flights allows you to search for flights using flight specific queries and returns results in a format that is most useful for comparing flights. This is the same service that other travel metasearch products offer.

Obviously travel metasearch companies think this is terrible! They were used to having the best product and capturing the ad revenue that airlines paid them when a potential customer clicked on a link to a flight. But Google Flights has been widely viewed by consumers as a fantastic innovation.

[Scott's Cheap Flights](#) is an online service that identifies when airlines put flights on sale or other deeply discounted fares and alerts their subscribers. The service has been widely praised by many media organizations and I use it personally. And what does Scott's Cheap Flights [tell](#) its subscribers is the very best tool for finding cheap flights? Google Flights.

But what have online travel companies said about Google Flights? They say Google is "increasing the ad load" and "degrading the user experience." The implication of this point of view is that Google Flights is an ad product (which it is) and by putting it at the top of the search results they are pushing further down the page "organic" (ie. free unpaid links) search results that point to the travel companies' own websites. Under this worldview, "paid" search results are "bad" for users and "organic/free" search results are what users are looking for.

But that's wrong.

Google Flights is a paid search product, but it is also the best search product to find the best flight. Users aren't being forced or tricked into using Google Flights simply because they have to scroll further down the page to see organic results. They are using Google

Flights because it does a better job of getting them the information they seek.

But Google Flights isn't a big deal to Booking Holdings, because the vast majority of Booking's revenue comes from booking hotels. And very importantly, most of their hotel booking revenue comes from hotels in Europe and Asia, not the US, which we'll explain the importance of a bit later.

About a year ago, Google rolled out [Google Hotels](#). And guess what? It is a really good tool for searching for hotels.

Over the summer, Google began "optimizing" their travel products. Said more bluntly, they have been strategically updating their algorithm so that users are more likely to go through their paid travel search products. When TripAdvisor, Expedia, and Booking reported their 3rd quarter results, the market did not like what it heard:



(Source: Bloomberg)

TripAdvisor and Expedia fell by 20%-30%. Booking declined as well, but the commentary from each company could not have been more different.

Here's Skift's [analysis](#) of what happened.

"The fact that Google is leveraging its dominance as a search engine into taking market share away from travel competitors is no longer even debatable. Expedia and

TripAdvisor officials seem almost depressed about the whole thing and resigned to its impact.

“We believe our most significant challenge remains Google pushing its own hotel products in search results and siphoning off quality traffic that would otherwise find TripAdvisor via free links and generate high-margin revenue in our hotel click-based auction,” TripAdvisor stated.

Expedia Group CEO Mark Okerstrom in Bellevue, Washington, said Google is taking “more revenue per visitor, and I think it’s just the reality of where the world is in the Internet, and the importance of Google at the top of the funnel.”

Both Okerstrom and Kaufer complained that their organic, or free, links are ending up further down the page in Google search results as Google prioritizes its own travel businesses.”

But here’s what Booking Holding CEO Glenn Fogel said at RBC’s analyst conference a few weeks later:

“We built this company on pay per performance to begin with and it’s no secret that we did it with Google. Google and us have had a very good relationship together. We’ve both benefited tremendously.”

While all three of these companies are online travel businesses, there is something [idiosyncratic](#) about Booking Holding’s business model. And this distinction is the critical key to why Booking and Google should best be understood as engaging in a mutual beneficial relationship. Sure, they might both want to maximize the profits they each earn, even at the others’ expense. But their relationship is not a zero-sum game. They both can win over the long term, which is why at Ensemble we’re very comfortable being long in both stocks.

Key Distinction #1

Unlike TripAdvisor, which is primarily a metasearch site which earns advertising revenue by sending users to hotels or hotel OTAs to reserve a hotel room, Booking is primarily a hotel OTA. Google is in the search business. They don’t book reservations in either their Flight or Hotel product. For that matter, across Google’s entire search related business they don’t enable users to engage in transactions on their site for the most part. They are in the advertising business and they earn their profits by generating advertising revenue in exchange for sending users to other companies’ websites to engage in transactions.

So, Google Hotels is a direct competitor to TripAdvisor. However, the search results inside of Google Hotels includes hotel websites, but also Booking and Expedia listings offering the ability to reserve a hotel room that fits the search.

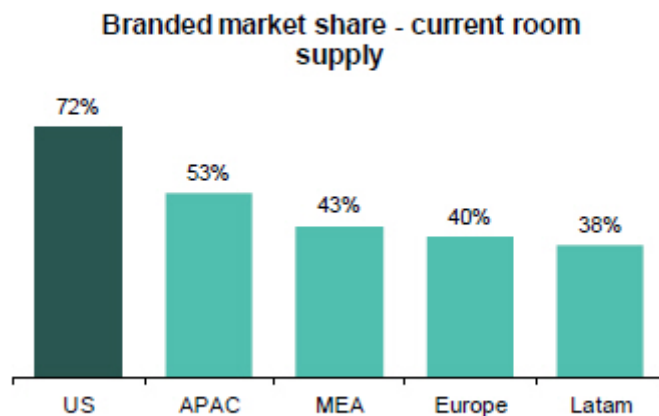
Key Distinction #2

Booking and Expedia are the two leading OTAs. But while Booking is mostly just hotels and mostly in Europe and Asia, Expedia has more exposure to airline tickets and far more exposure to the US.

Empty hotel rooms are like perishable inventory. If you don't sell a hotel room one night, you can't ever sell that room on that night again. This is why hotels are willing to pay OTAs a large commission for finding a traveler to book a room.

In the US, where Expedia is more exposed, the market is dominated by big branded hotel chains such as Marriott, Hyatt and Hilton. When a traveler heads to New York, rather than going to a metasearch or OTA website, they might just go right to Marriott or Hyatt or Hilton's website. These companies have strong loyalty programs and are well known to customers. Their hotels tend to run with higher occupancy rates and so they aren't particularly dependent on the incremental demand that OTAs can provide. Indeed, OTAs have had to negotiate much lower commission rates with the big brands.

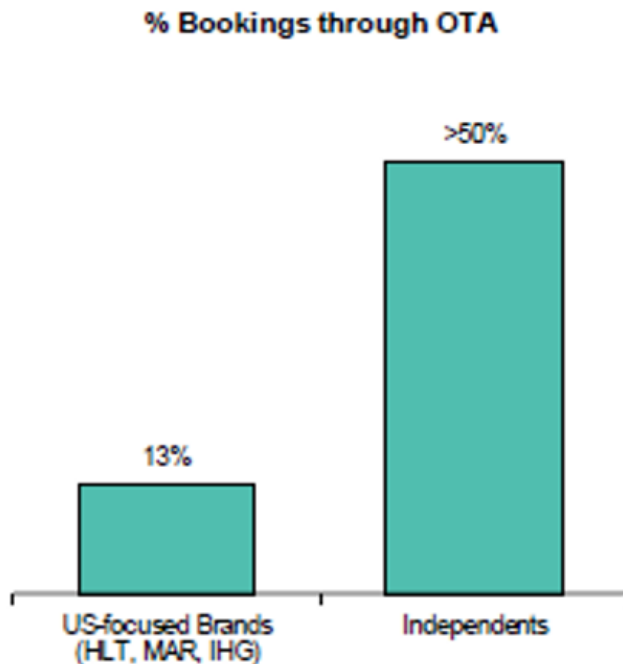
EXHIBIT 53: The US has the highest level of branded market share, with independents still dominant in the rest of the world



Source: STR, Bernstein analysis

But in Europe and Asia, where Booking is more focused, independent hotels are the norm. If a traveler is going to Milan or Bangkok or Paris, they are much more likely to stay at an independent hotel. These hotels don't have loyalty programs or global brand recognition. They tend to operate with lower occupancy rates. With more "perishable inventory" going bad every night, independent hotels are much more dependent on OTAs and pay a much higher commission rate than branded hotels.

EXHIBIT 8: Independent hotels are far more dependent on OTA bookings than members of large branded networks



Source: Company reports and Bernstein analysis

For independent hotels, Booking and other OTAs effectively act as outsourced digital marketing companies who are paid on commission. This is an incredibly valuable service for independent hotels who simply don't have the resources or expertise to run global digital advertising programs.

This is why the hotel listings inside of Google Hotels will typically be direct links to Hyatt or Hilton or Marriott's own website (bypassing the OTAs), but for independent hotels the links will typically be to Booking or other OTAs' listing for the hotel.

Key Distinction #3

If TripAdvisor, Expedia and Booking all have their hotel listings inside of Google Hotels, why are Expedia and TripAdvisor moaning about it while Booking doesn't seem to care?

Remember those "organic" or free links that TripAdvisor and Expedia are saying are being moved further down the page as Google "pushes" users into the Google Hotels product (or

rather users choose to use Google Hotels because it is a better experience than general search)? That traffic is referred to as SEO (search engine optimization) traffic. TripAdvisor and Expedia have been free-riding on Google’s service while Booking generates its earnings stream from paid Google links.

This is the most important distinction of all.

<i>Cowen OTA SEO Exposure Analysis</i>	SEO % of rev	Incremental margin %	SEO effective profit margin %	Overall EBITDA margin %	Effect. EBITDA exposure to SEO
TRIP	30%	95%	29%	30%	95%
EXPE	10%	85%	9%	17%	50%
BKNG	7%	90%	6%	41%	15%

Source: Cowen and Company estimates, company reports

While the companies’ do not disclose the amount of traffic they receive from organic vs paid links, the above analysis by Cowen & Company aligns with the companies own past comments and our analysis of the companies’ business models.

TripAdvisor and Expedia are dependent on Google’s *free* search results for the majority of their earnings. While Booking uses Google’s *paid* advertising search results to drive the vast majority of their earnings.

TripAdvisor and Expedia complain that Google is “increasing the ad load,” “degrading the user experience,” “pushing its own products,” and “siphoning off quality traffic.” But there is another way to think about what’s going on.

Here’s venture capitalist Chamath Palihapitiya [speaking](#) in his typically bombastic manner at the recent Phocuswright travel industry conference:

*“If you are a business that thrives inside of this Google environment... you are f***ed. Ratably, tick for tick, every single person that feeds off of them, will see their profitability erode. That’s the unvarnished truth of what’s happening. If you are in the business of being a parasite on top of Google, your medium and long term prospects are terrible. You are an impaired company, even though you don’t know it.”*

While Palihapitiya is prone to dramatic statements, venture capitalist Bill Gurley who is more balanced in his public comments [retweeted](#) Palihapitiya’s statement saying simply “this is accurate.”

Bottom Line

Booking and Google are not at war. Booking is one of Google's biggest customers. Booking built its business model around paid links from Google. Google has found a way to offer metasearch for hotels in a way that offers a superior user experience and has the benefit of Google getting paid for sending users to other sites to book rooms. This is hugely disruptive to companies built on the idea that somehow they deserve to get free traffic from Google. But it is not disruptive at all for a company like Booking that has figured out how to pay Google even while it earns fantastic profits.

For more information about the positions owned by Ensemble Capital on behalf of clients as well as additional disclosure information related to this post, [click here](#).

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