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PRESENTATION

Operator

Good day, and welcome to Expedia's Q2 earnings call. Today's conference is being recorded. At this time, I would like to turn the conference over to Alan Pickerill, Senior Vice President, Treasurer and Head of Investor Relations. Please go ahead, sir.

Alan Pickerill - *Expedia, Inc. - SVP, Treasurer and Head of Investor Relations*

Thank you. Good afternoon, everyone. Welcome to Expedia, Inc.'s financial results conference call for the second quarter ended June 30, 2017. Pleased to be joined on the call today by Dara Khosrowshahi, Expedia's CEO and President; and Mark Okerstrom, our CFO and EVP of Operations.

The following discussion, including responses to your questions, reflects management's views as of today, July 27, 2017, only. We do not undertake any obligation to update or revise this information.

As always, some of the statements made on today's call are forward-looking, typically preceded by words such as we expect, we believe, we anticipate or similar statements. Please refer to today's press release and the company's filings with the SEC for information about factors which could cause our actual results to differ materially from these forward-looking statements.

You'll find reconciliations of non-GAAP measures to the most comparable GAAP measures discussed today in our earnings release, which is posted on the company's IR website at ir.expediainc.com. I encourage you to periodically visit our Investor Relations site for important content, including today's earnings release.

I'd like to remind you that beginning in Q1 '17, we include HomeAway on-platform gross bookings and property nights in our operational metrics, and such balances have been added to prior year's gross bookings and room nights for a clean comparison.

Finally, unless otherwise stated, all references to cost of revenue, selling and marketing expense, general and administrative expense and technology and content expense also exclude stock-based compensation and depreciation expense. And all comparisons on this call will be against our results for the comparable period of 2016.

With that, let me turn the call over to Dara.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Thanks, Alan. We're pleased with our second quarter results, which when combined with Q1, stack up to a healthy first half of the year. For Q2, gross bookings grew 12%, revenue grew 18% and adjusted EBITDA grew 19% year-on-year. In total, stayed room nights were up 21% in the second quarter, evidence of a healthy macro environment and solid execution as we work to grow our business around the world.

In our Core OTA segment, we continued to see good momentum, evidenced by faster room night growth in every major region. Our global brands continue to grow room nights at a very healthy pace as they made aggressive marketing investments across channels. Execution in variable marketing channels continued to improve, a trend which we also see early in Q3 and which we expect will continue in the back half of the year. Success here will improve new customer acquisition trends, but hurt profit margins as we lean into these channels.

On the regional brand side, we're happy to continue to balance healthy adjusted EBITDA margins with a more modest top line growth.

The HomeAway transition continues according to plan, with gross bookings up 45% and revenue up 31% year-on-year. We're systematically improving the online booking experience as well as supply-side tools and taking deliberate steps to move more of our bookings on platform.

For example, we recently introduced the new closed system for owner and traveler communications and also require that all new and renewing subscription properties be online bookable. These changes represent industry best practices and serve to improve the overall experience and protection of our travelers, homeowners and property managers.

We continue to put the vast majority of HomeAway's revenue growth right back into the business, with significant investments in product and technology and marketing. In particular, we're making good progress implementing world-class performance marketing capabilities with the right people, process and technology.

Lastly, we're pleased to end the quarter with nearly 1.5 million online bookable listings and over 60,000 HomeAway properties available for booking on 11 Brand Expedia points of sale. Expect the number of integrated properties to continue to grow as we move through the year. We remain confident in the stellar HomeAway team and happy with the business transition as we pursue this enormous long-term opportunity.

We're also happy to say that Egencia is now the fourth-largest travel management company in the world based on revenue. Gross bookings grew 5%. Revenue grew 8%, with the top line negatively impacted by Easter timing as well as the churn of certain Orbitz for Business customers during last year's migration, an impact that should continue to ease as we move through the back half of the year. New customer signings in Q2 were on track and the global sales pipeline looks good. As we mentioned last quarter, Egencia started to ramp up hiring of additional salespeople as we step on the gas to take advantage of a large global opportunity ahead.

trivago continued its blistering pace of revenue growth, with stand-alone revenue up 64% year-on-year. Adjusted EBITDA was nominal in Q2 as the team continued to invest in selling and marketing around the world to continue to grow their audience and brand. As announced separately by trivago today, we continue to expect revenue growth of around 50% for the full year, with slightly improving adjusted EBITDA margins.

I'd like to officially welcome the SilverRail team to the Expedia family and spend a minute talking about rail and how it fits into our portfolio. Rail tickets are a high-frequency product of growing importance in Europe and Asia and represent another key component of our multiproduct and corporate travel strategy.The Brand Expedia team continues to build out the world's most complete selection of online travel products, giving consumers unparalleled convenience and savings opportunities through the shopping and booking of multiple components of their trip. SilverRail has a great opportunity ahead as a stand-alone enterprise and has done a terrific job building rail technology and beginning to assemble ticket content. The combination of the SilverRail offering with the rail product rolling out on Brand Expedia as well as Egencia will be quite powerful. This will be a multiyear project, but we're happy to have jumped into a great position that we can build on in the coming years.

Finally, you'll notice that we announced a $350 million minority investment in Traveloka and deepened our global hotel supply relationship with them. Traveloka is a clear online leader in Indonesia and is expanding aggressively throughout Southeast Asia. We're incredibly excited to continue to expand our presence in Asia and to learn from Ferry and the talented Traveloka team and to unlock a more diverse offering of travel choices for Traveloka and Expedia travelers around the globe.

In closing, we're pleased with our results for the first half of the year, and I'd like to thank our employees around the world for all of their contributions to get us here. It's gratifying to be back into our operational rhythm of continuous improvement and execution across the company. The good news is that we believe we can get better, faster, more efficient and more effective in many, many areas. We've got plenty of work ahead of us, but we're up for the challenge. Mark?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Thanks, Dara. Q2 was a solid quarter and demonstrated continued strength in the business. Total lodging revenue, including both hotel revenue and all of the HomeAway revenue, grew 16% for the second quarter, driven by stayed room night growth of 21%.

Room night growth was 19% for the hotel business and 42% for HomeAway. In the hotel business, we saw a 4% reduction in revenue per room night versus flat ADRs for a gap of about 400 basis points, which was in line with our expectations. We are pleased with execution across our lodging business, which translated into strong results. But of course, we did also benefit from the shift of Easter into Q2 this year and easing unit growth comps.

HomeAway gross bookings grew 45% while revenue grew 31% to $224 million. Stayed property night growth was a robust 42%. Transactional revenue grew approximately 130% year-over-year, decelerating somewhat from Q1 as we began lapping over last year's launch of the traveler service fees. As expected, subscription revenue was down around 35% year-over-year as we continued to see the impact of having eliminated the tiered subscription model in July of last year. We also saw an increasing number of subscription listings moving to lower online bookable pricing and also the transition of properties from subscription to the pay-per-booking model. We expect these general trends to continue in the back half of the year, with HomeAway's revenue growth peaking in Q3. Adjusted EBITDA for HomeAway in Q2 grew slightly and was largely in line with our expectations.

Advertising and media revenue of $302 million was up 49% year-over-year. On a stand-alone basis, trivago revenue grew 64% year-over-year on strong volumes and solid monetization as consumers continue to flock to the platform and as advertisers continue to find trivago a compelling place to acquire highly qualified traffic.

For another quarter, the shape of our P&L was in line with our target as we continued to contain our fixed costs while investing aggressively in global selling and marketing. Cost of revenue grew just 6% year-over-year in Q2, leveraging nicely. Note that we are forecasting somewhat higher growth in overall cost of revenue in the back half of the year due in part to increased cloud spend, but also the lapping of certain efficiencies we gained through the transition of Orbitz to Expedia platforms in the first half of last year.

Total selling and marketing expenses grew 27% year-over-year, driven by direct expenses up 30%. We continue to push for global growth, led by aggressive marketing investments at trivago, Brand Expedia, Hotels.com and HomeAway. As we look forward, we plan to push further on the performance-based channels and to amplify our hotel acquisition efforts by further ramping up our hotel market management sales force, both of which represent a headwind to near-term profitability. We continue to expect total selling and marketing costs to grow faster than revenue for the rest of the year.

Technology and content grew 9% year-over-year in Q2. Inclusive of cloud costs, we expect to see slight leverage in this line item for the full year. The growth in the back half of the year, however, is expected to be ahead of revenue growth due in part to cleaner comps on the Orbitz integration, heavier cloud spend and the hiring of additional technology talent.

Our cloud migration project continues to go quite well and in line with our expectations. Total cloud spending for the quarter was $21 million, up from $9 million the same period last year, with a roughly 60-40 split between cost of revenue and technology and content. Cloud spending is expected to ramp significantly in the back half of the year.

G&A expenses grew 3% in Q2, leveraging nicely, with increased professional fees and other costs largely offset by lapping over the Orbitz and HomeAway integration costs last year. We expect to see good leverage in G&A for the full year.

From a capital deployment standpoint, in addition to the SilverRail and Traveloka investments, we've repurchased nearly 1 million shares so far in 2017 for a total of $134 million. Our long-standing approach to capital deployment has not changed, and we continue to balance share repurchases, our quarterly dividend and opportunistic M&A.

We are pleased to have again increased our dividend to $0.30 per share, to be paid in the third quarter. Turning to our financial expectations for full year 2017, on a consolidated basis, including the ramp-up in cloud spending, we continue to expect adjusted EBITDA growth in the range of 10% to 15%. Excluding cloud expenses, growth would be 14% to 19%.

With that, let's turn to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

This is the operator, can you hear me?

Alan Pickerill - *Expedia, Inc. - SVP, Treasurer and Head of Investor Relations*

Standby, everybody. Operator, we cannot hear you on the speaker line.

(technical difficulty)

Alan Pickerill - *Expedia, Inc. - SVP, Treasurer and Head of Investor Relations*

Hello, we can hear you now.

Operator

(Operator Instructions) And let's go ahead with our first question from Justin Post with Merrill Lynch.

Justin Post - *BofA Merrill Lynch, Research Division - MD*

Great. A couple of questions. First, on the business. How is HomeAway conversion performing as you've added more properties and made more properties online bookable? What are you seeing with conversion rates? And are you still expecting some pretty good leverage next year? And then on the second question, on the EBITDA guidance, looks like you're keeping it at 10% to 15%. But obviously, EBITDA is growing much faster in the first half, which is somewhat unusual. As you accelerate marketing spend, would you expect to see that in any operational metrics, like room nights or bookings, or how would we see that flowing through the model?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Thanks, Justin. As far as conversion for HomeAway goes, the conversion rates are very healthy and increasing on a year-on-year basis. There are a number of factors that are benefiting conversion. Clearly, adding to the breadth and depth of supply and getting more of that supply to be instant bookable is a positive factor on conversion, so that's affecting conversion. Second positive factor for us is sort. And we have some terrific data scientists down at HomeAway who now have more freedom as far as their sort experimentation goes and are now sorting properties who have a higher online booking success rate, for example; whose response to consumers, as far as the request response model, is higher; whose experience reviews are higher, et cetera. So the sort team is now -- has many more degrees of freedom to sort the stuff that is able to convert online as well. Third factor is just testing and learning on the site. We are very, very early on the development of the site, of the optimization of the consumer experience. We have some terrific UI and product folks. And I think the ideas, while flowing, are just starting to show up on the sites. We've consolidated the back end of many of the sites out there of the various brands so that when we drive improvements in experience, they can be propagated through all of our sites on a global basis very, very quickly. And then I think the recent moves to move communications to our internal secure channels, for example, is also going to be a conversion tailwind. So we see conversion going up and we see that continuing. And frankly, we need it to continue, we expect it to continue in order for us to hit our plans. But so far, so good.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

And then, Justin, on guidance. Yes, in fact, we're keeping our guidance where it is. And just a couple of things to remind you of. If you look at last year, about 2/3 of our dollar-adjusted EBITDA was produced in Q3 and Q4. So there's a lot of the year left to come. And this year particularly, we just have tougher comps as we move through the back half of the year on expenses. And that's because right now, we're benefiting from lapping over kind of the first half of last year, where we were heavied up in association with the integration. As then as you recall, we started to realize the expense synergies through the back part of the year. Quite frankly, we also want to keep the flexibility to make investments. We don't lock and load on our plans at the beginning of the year and stop there. We're making decisions every quarter. And when we see the types of returns and progress that we have been seeing with investments in market manager sales force, for example, to add hotel properties, that's the type of thing that we want to have the flexibility to do more of in the back part of the year. That's the plan, and we may amp it up from there. Selling and marketing is another place where we like to invest in. We have been pretty aggressive in variable marketing channels through the first part of this year. We expect that to continue. Whether we do something incremental in approach to what we've been doing, I wouldn't necessarily say that. We haven't made those decisions. So I would actually expect that in terms of where this shows up in the P&L, although there could be some opportunity in performance marketing for room night growth, really, the bulk of the investments are things that are more kind of longer term in nature and things that are unlikely to produce real results within a quarter. It's more likely to be sort of more long term in nature.

Operator

Our next question comes from Paul Bieber with Credit Suisse.

Paul Judd Bieber - *Credit Suisse AG, Research Division - Director*

I was hoping you could elaborate on your comments on improved variable marketing execution in the second quarter. And I think you said that you expect that to continue in the back half. And then just following up on Justin's question. How are the conversion rates of HomeAway properties on other Expedia properties trending? I think last quarter, there were 20,000 rooms on Expedia and Hotels.com, and now there's 60,000 rooms. What should we read into -- about the conversion rates given that trend?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Sure. As far as the variable marketing channels, the business itself is pretty basic in that we are getting back into the testing and learning. And I'd say conversion rates are healthy on our various sites. Obviously, they're hurt as more traffic goes mobile but, in general, we're happy with the testing and learning on the sites. Higher conversion means the ability to extend your marketing, especially on the marketing channels. And I would say that we are getting -- we're improving our capability in terms of data science and in terms of just integrating our marketing technologies into our mainline data and site technologies, which is allowing us to reach a greater breadth of variable channels than we have heretofore. The trivago channel, the meta channels in general, are very healthy for us and search continues to be healthy. So as long as they're healthy, we plan to lean into them because these are spend that certainly come through on a lifetime basis and it's a set of new customers who's going to repeat with us and it's something that makes sense.

As far as conversion of HomeAway properties on mainline Expedia, it's very early, right? So the -- I think you will see the number of HomeAway properties ramp up on the Expedia sites. We've seen some promising early signs, especially as we've gone from kind of the 20,000 to the 60,000. There's still a bunch of testing that we have to do around sort order, around trying to detect signal from a customer as to when is it that a particular customer will be more likely to be searching for vacation rentals, et cetera. So lots of testing and learning to do. Good early signs, but off of a very small base. And we hope to build that base as the year moves on.

Operator

Our next question comes from Mark Mahaney with RBC Capital Markets.

Mark Stephen F. Mahaney - *RBC Capital Markets, LLC, Research Division - MD and Analyst*

I kind of want to ask the exact same question that Paul just asked, but maybe slightly differently...

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

You know what, Mark? Mark, I'm going to let Mark answer the question. Since you're going to ask the same question, I'll let Mark answer it.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

I might do that, but just slightly differently.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, there you go. Go ahead, Mark.

Mark Stephen F. Mahaney - *RBC Capital Markets, LLC, Research Division - MD and Analyst*

Okay, then. I'm very intrigued by the bringing over of the HomeAway inventory onto the Expedia sites. And so instead of asking what the impact is on HomeAway conversion, what I want to ask is what the impact could be on Expedia and Hotels.com core conversion. I would think this is a big win for you. But I don't know where along the way you have to make the tweaks, the testing and the learning. Is it trying to figure out how the traffic's coming in off of search or other paid channels? Or is it that when you're on the site, how you match them up? Like, if you could just go through a little bit of the sausage on that, like -- I think it's a great opportunity, but if you could go through it. And then just a quick one, any comments on social media, particularly Facebook, as a marketing channel? All the other channels sound healthy, but you didn't mention that. I think it's always been small for you. Is there any reason why it wouldn't be anything more than small for you in the future?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Sure. So on conversion on Brand Expedia -- and first of all, the HomeAway inventory is only right now on Brand Expedia. And on -- very recently, on 11 points of sale. We recently expanded it. We generally agree with you that this is a big opportunity for us. As a general rule, what we find is that when you expand assortment and inventory for a specific destination, you just have more likelihood of having something that a customer wants. And that's generally evidenced in conversion. The trick with this type of inventory, though, is that it's different. So when you have travelers that are shopping on a site, you don't know right out of the gate whether they're looking for a 4-bedroom home or whether they're looking for a single bed. So now you just have to start to understand the traffic you're bringing in, whether it comes with some sort of purchase intent, how do you match them up with a landing page that may be tailored to that intent to be vacation rentals. You have to start thinking about your sort filters. You have to start thinking about sort order. And there's a lot of different testing you have to do to try to, again, match the purchase intent with what you show them. It's a science, but there's also some art to it. The great news is, is that we've got a team at Brand Expedia and across our leisure brands who this is what they do for living and this is the machinery. So we're confident that we're going to get there, but it will take some time.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

And the great news there is also you've got the HomeAway team, which is continually optimizing their sites and what works, what kind of content users are looking for. So the HomeAway team are kind of our leading commandos and our Expedia team can learn from the commandos and build a very effective product. So we're pretty optimistic here. It's -- right now, HomeAway on Expedia is in the very, very early innings and we expect more.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Do you want to take the Facebook part?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes. As far as Facebook, spending is still -- it's continuing to grow off of what is, compared to our whole spend, a relatively small base. But the Facebook spending growth is quite healthy. We are testing and learning and working kind of on an engineer-to-engineer basis with the Facebook team, and they continue to improve their product. I think we are looking at the incrementality of a bunch of the retargeting product that they've got, and also looking really aggressively to find intent signal, travel intent and destination intent signal in their huge, huge audience. So we are optimistic, the channel keeps growing, and we just want to keep it going. Every day, every week, the focus here isn't on how big the prize is, it's just getting on better -- it's just our teams getting better and better and better on the execution front.

Operator

Our next question comes from Eric Sheridan with UBS.

Eric James Sheridan - *UBS Investment Bank, Research Division - MD and Equity Research Internet Analyst*

Maybe 2. Good result on the room night growth. Obviously, big improvement from what we saw in Q1. Any sense you can give us on the conversion between booked versus stayed room nights and how that might arc through the year so investors can sort of better understand what the pace of room night growth might be as we move through the year? And then second question. Going back to the loyalty and reward layer inside some of your key properties. Anything you could share there about how increased loyalty and rewards or duration of being in those programs might change customer lifetime value and how that might be changing over time?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Sure, Eric. So the best way to look at the booked versus stayed gap is if you take a look at the year-to-date stayed room night growth number, it's around 17% for essentially the hotel business, excluding HomeAway. And that compares with last quarter, we disclosed the booked room night growth of 18%. And I'll tell you this quarter was broadly similar. In terms of looking out through the rest of the year, I would just remind you that we pulled back pretty sharply in variable marketing channels in Q2 and in Q3 of last year, and then went back in pretty significantly starting in the fourth quarter. So you will start to see some harder comps for us moving into the fourth quarter that will shape up the overall full year number.

In terms of loyalty and rewards, first of all, we're a big believer in the loyalty program, particularly of the Hotels.com Rewards program at -- where you stay 10 nights and you get 1 free. We find that on a pre and post basis, when you look at cohorts, customers that sign up for the loyalty program are just more likely to give you a bigger share of your wallet, more likely to come back to you via your app or direct channels. And all in, it ends up being a good thing. And then generally, the longer people are with the program, the more used they get to it and the more active they become as well. So generally, it's a net positive. Of course, you've got to be very careful and make sure that you manage the program closely and make sure that you're awarding points appropriately and not essentially rewarding members who aren't loyal to you, for example. But that's something that the Hotels.com team is very good at and continues to get better at over the many years they've been at it.

Operator

Our next question comes from Ross Sandler with Barclays.

Ross Adam Sandler - *Barclays PLC, Research Division - MD of the Americas Equity Research and Senior Internet Analyst*

Question on -- another follow-up on the room night. I think you said last quarter that the global brand room night was up 17%. I don't recall -- I can't remember if that was booked or stayed. But what was that this quarter? And I guess, normalizing that for booked versus stayed, what does that trend look like? And then, I guess, just looking forward, what's the overall strategy in terms of managing some of the nonglobal brands, the legacy brands? And are those businesses continuing to kind of grow or are they flattening out? Like, what -- any color there would be helpful.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Sure, Ross. I think Dara and I will tag team on this one, but let me just run through some of the numbers first. So I'd say, generally, the global brands number is not something that we're going to disclose always on an ongoing basis. We'll do it when it's helpful to tell the story and, otherwise, we'll kind of just do it periodically. I will just give you a little bit more color, though, on just the composition of our room nights because it is a question we get very frequently. Somewhere between 85% and 90%, depending on the quarter, of our room nights are delivered by our global brands, which are Expedia(Brand Expedia), Hotels.com, EAN, which is our private-label business, and Egencia. This quarter, I would think about growth on a stayed basis of kind of in the 20s. And Easter was about a 200 basis point helper for us this quarter across the whole portfolio. And I would think the impact on the global brands will be broadly the same. We then go to what we call our regional brands. And this is the consumer-facing piece of our recent acquisitions, being Wotif, Travelocity, Orbitz, CheapTickets, ebookers, for example, excluding the Orbitz Partner Network business. That is -- think about that as in the kind of high single-digit range of our overall room nights. That business has been flat to slightly up. And then the remainder is largely made up of Hotwire and the legacy Orbitz Partner Network business that we've now integrated with the Brand Expedia business. And as you recall, when we migrated that business over, there was a large number of partners that we just didn't keep with us. And these were partners who wanted particular customizations we weren't ready to do or partners who were empty calories, essentially profitless or loss-making room nights. And so that part of the business has been down pretty significantly. Dara, do you want to cover kind of how we're managing the...

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, just as far as the strategy for the nonglobal brands, in general, these brands are on the Brand Expedia platform. And to the extent that our platform improves, especially on the conversion side, more than the competitive set, the aggregate competitive set, you're going to have conversion as a tailwind and these brands will get to kind of ride on the conversion tailwind. So our expectation is that over a long period of time, these brands are going to grow. How fast will they grow, as fast as the online travel markets or with the travel market, is to be proven. The teams are really starting to get an operational rhythm. There's a group of folks who are coming together kind of under one roof that are working on these brands. And while we won't be as aggressive, especially in the variable channels, as we are with some of the global brands, we will look for a higher ROI on the next dollar of marketing spend. These brands do spend significant marketing dollars. We are looking to kind of get their, establish their own personality as far as what the brand means and what it communicates and how they serve their core customer. And each of them have their own core customer. And I think that playbook is really just starting to come together. So we're optimistic about the global brands, and we expect high profit margins. We're not going to see the kind of growth that we see in the global brands, but we do expect growth going forward. But we have to prove that out to you, and it's certainly our intention to.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes, the only slight thing I'd add there is just to remember the regional focus of these brands, too. That even with excellent execution, they are in regions which are generally much more mature than the overall market and don't have exposure to some of the faster-growing markets that the global brands do, and this is namely the U.S. and Australia and New Zealand in the case of Wotif.

Operator

Our next question comes from Mike Olson with Piper Jaffray.

Michael Joseph Olson - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

I just have one question. So Traveloka sounds like it provides you with a new opportunity to expand in Southeast Asia. Are there other markets where you could bolster your existing offering through acquisition or potentially through organic efforts? And I guess in other words, where else do you think you're maybe under-indexed and could invest more, if any?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes, great question. I think, first of all, we are incredibly excited to have Traveloka as an even closer partner. They've really performed exceptionally well and, in a relatively short period of time, has -- have established themselves as a real leader in Indonesia, expanding throughout Southeast Asia. So we're very impressed with them and very impressed with the management team. We're hopeful that we can use some of our global expertise to help them, and we expect to learn a lot from them as well.

In terms of opportunities in other markets, I would say that we are under-indexed in almost every single market in the world aside from the United States and Canada. So we see this as being a huge amount of opportunity. And I think, again, on a business that is, call it, $80 billion of bookings in a market of $1.3 trillion, we've got a ton of runway ahead of us. I think the opportunities ahead of us are, I'd say, largely organic in nature. We've got some pretty amazing global growth brands. We've got the capability to add new hotels at an increasingly fast clip. We've got the technological capability to add new airlines. We've got the marketing capabilities, that Dara spoke about how we're getting better and better there. So I think we've got an incredible organic runway ahead of us. But as is the case with Traveloka, as is the case with our investment in Despegar, part of this is not only an operational story, but also a capital deployment story. And we're going to continue to look for ways to deploy capital in smart ways, either through full acquisitions, as we have certainly done in the past, but also through smart investment in leading players where we think we can potentially help them and where they can potentially help us.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Just the other factor I'll add here is that we believe that our Expedia Affiliate Network business, this is our private-label business that wires up our global inventory to really a global base of affiliate partners out there, this is a team that because of our inventory is able to detect a lot of little local players who are growing up. Because as these local players grow up, often, they start booking big amounts of travel into the U.S. and into Europe. So having the affiliate team out there allows us to detect kind of who the early local players are. The EAN business team gets to work with these local folks, and they're like, "Wow, these Traveloka folks are really smart and they're growing really, really fast," which then, of course, alerts kind of our strategy teams, et cetera. So we have a bit of an early-warning system, not only in terms of our supply folks who are on the ground, but also in terms of our private-label folks who are growing very, very fast and continue to expand their relationship with many, many brands out there around the globe.

Operator

Our next question is from Jed Kelly with Oppenheimer.

Jed Kelly - *Oppenheimer & Co. Inc., Research Division - Director and Senior Analyst*

HomeAway international bookings still appear to be less than 30% of the overall site bookings. Can you discuss some of the different competitive dynamics with HomeAway internationally versus domestically? And what procedures can be implemented to accelerate HomeAway's online bookings internationally?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, it's a great question. In general, what I'd tell you is that, obviously, with VRBO and the HomeAway brand, the -- those 2 brands are very, very strong domestically and are not as strong internationally. And one of our very significant growth opportunities over the next 5 years with HomeAway is to expand internationally. As it relates to the order of operations, our focus has been mostly domestic this year. And you can expect our focus to turn from domestic to growing the international markets. We think there's a lot of potential, but there's also a lot of work ahead of us. So this year is about domestic and next year is about global for the HomeAway team.

Operator

Our next question comes from Brian Fitzgerald with Jefferies.

Brian Patrick Fitzgerald - *Jefferies LLC, Research Division - MD and Senior Equity Research Analyst*

Maybe on your cloud spend. Mark, you talked about it ramping in the back half of the year. If you had to say what inning you are in terms of the cloud spend and the migration process, could you give us that? And then are you finding the process is accelerating as you progress? Last question around kind of the cloud stuff is, you mentioned that 60-40 split of the spend. Does that mix stay consistent as you go through the back half of the year?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes, so it is ramping up in the second half. If I was going to give it a baseball analogy, I don't know, second or third inning, I'd say. It's going to be a relatively long game, though, so we might go to extra innings. We'll see. I'd say that it's not necessarily accelerating. I'd say the team is getting better and better and better at not only migrating code into the cloud, but once they get there, optimizing it. And so it's sort of a migration and optimization progress. We want to get there quickly, but we want to get there smartly. And so the team's going as fast as they can within reason, making sure that, again, they do it in the most intelligent way. In terms of the mix, I'd say on a full year basis, the mix is more like 50-50. So you'll see probably a shift of more of it into R&D through the back part of the year.

Operator

Our next question comes from Doug Anmuth with JPMorgan.

Douglas Till Anmuth - *JP Morgan Chase & Co, Research Division - MD*

I just wanted to ask you guys about the strategy in building out supply. Dara, I think you talked about -- or maybe it was Mark, about just pushing harder with hotel salespeople in the back part of the year. If you could talk more about that. And how do you try to balance supply growth with your ability to drive consumer demand? And then also, how are you kind of thinking about weighting hotel property growth and then HomeAway on Brand Expedia?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Sure. Sure, absolutely. As far as the -- I'll answer the last question first, weighting HomeAway and Expedia growth. Both of those teams are moving hard on supply, hotel supply, and alternative lodging supply as quickly as they can. So it's not an or, it's an and. And the teams are moving fast and running. And we absolutely intend to add significant supply, both on alternative lodging and in hotels on a global basis, really, for the foreseeable future.

As far as our supply strategy and build-out, we have consistently seen that as we sign up hotels and we bring them onto the system, we are able to deliver demand to those hotels. And we're very carefully watching the balance of new hotel signings, how quickly we bring them onboard, how quickly you get the first booking, and our kind of penetration or demand into each individual hotel in a particular market, so that if you have a market where you are theoretically acquiring too many hotels, you would slow down because your demand is thinning out. Now in reality, we're not seeing that very often. Most of the time, if not the vast majority of the time, as we add hotels, the system is able to create demand. Every hotel is another auction that we can enter in some of the variable channels. As we add more hotels on a destination basis, usually, destination conversion increases. So this machine is working. And as we see it work, we get more confident in our ability to execute against it. And as we get more confident in our ability to execute against it, usually we put more capital behind it. So that is certainly going to be a part of our strategy. How fast we go depends on how fast we can create demand and how much throughput the teams have. But so far, they've given us reason to be confident in their ability to execute.

Operator

From Peter Stabler, Wells Fargo Securities.

Peter Coleman Stabler - *Wells Fargo Securities, LLC, Research Division - Director & Senior Analyst*

One or 2 on HomeAway. Dara, going back to the international expansion comment. I mean, HomeAway today has a dozen brands. We know that some of them are really small, but it seems to be regionalized. So when you think about expanding HomeAway internationally, is it -- what is it, a build or a buy strategy? Does the HomeAway brand become more front and center? Or do you look for a continuation of the strategy that exists today, where you have an opportunity to pick up stronger localized brands? And then second quick question. Wondering if you can comment on just kind of overall trend in terms of direct traffic. I know you're not going to give absolute numbers, but trends on direct traffic. And is mobile -- the shift to mobile a drag on direct traffic visits?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Sure. As far as HomeAway international expansion, HomeAway historically had grown significantly through acquisition. And while we do have regional brands, the vast majority of those regional brands are now on the mainline HomeAway platform and, as a result, getting the benefit of all the technology investments that we're making to improve the consumer experience and the supplier experience on the platform itself. While Mark and I are ones never to say no to acquisition, we do believe that the majority of our growth on a go-forward basis, as it relates to HomeAway, is going to be on an organic basis. We just think the service can get so much better. We are already investing in non-U.S. growth in Asia, et cetera, but we just think we can step on the gas over the next couple of years. When -- going back to Mark's comment about our under-indexing outside the U.S., that is even more true of HomeAway. And we just think that the opportunity in Europe, in Asia and Latin America is enormous and we certainly plan to get to it. But we do believe it'll be organic than through acquisition.

As far as mobile goes, listen, the trends in direct traffic, I would say, are similar to the trends that you see on desktop in that mobile Web is a very, very fast-growing channel for us as far as new customers go, especially internationally. A lot of those new customers come through paid channels. And then our teams are continually optimizing, moving those customers from mobile Web into our various apps. And that's just the continuous optimization and process that goes on. Frankly, I think we can do better there and I think the teams are certainly planning to do better there. Our app channel, our app direct channel, is very healthy. It's one of our fastest-growing channels. So I think that mobile Web, it's kind of the same game plan that you see on desktop, which is capturing new customers through variable channels, give them a great experience and that gets them to come direct the second, third, fourth, fifth time. No difference so far.

Operator

Lloyd Walmsley with Deutsche Bank.

Lloyd Wharton Walmsley - *Deutsche Bank AG, Research Division - Research Analyst*

First one is room night trajectory seems really solid and it seems like you've got plenty of runway in terms of adding new supply across hotel, across vacation rental. Wondering how we should be thinking really about the medium-term room night growth profile. Do you think it can kind of sustainably get back to 20%-plus type of growth rates over the next couple of years? And then second one, if I can, looking at margins, Core OTA margins did expand nicely in the quarter. So as we kind of look to '18, you're expecting to scale revenue and profitability at HomeAway. We kind of have that target P&L from last year's Analyst Day. But what types of things, like cloud investment or other investments or abnormalities, should we keep in mind as we start to think about the business beyond the next few quarters looking out to '18? Anything you'd call out?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, as far as the room night trajectory, we're not going to characterize a room night trajectory going forward. We'll do our best. We're happy with how the year has progressed and we hope it gets better. But that's about all we'll say about room night trajectory at this point on a go-forward basis. Mark, do you want to talk margins?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes. So on margins, I think just as a reminder, in the first half of this year, again, we benefit from comps on the margin front. Last year in the first half, we were carrying some extra costs, essentially. So on a year-on-year basis, they look particularly good. I would just say also that, as we've said before, we are absolutely not managing this business to adjusted EBITDA margin. We're managing for adjusted EBITDA, EPS and free cash flow growth. And in many cases, because of the formula we operate on, when we do good things and drive better conversion, it drives higher performance in performance marketing channels, which can drive higher bottom line growth that might actually hurt margins. And we think that's a fine thing to do. I'd also just keep in mind, if you're looking at the numbers, including the cloud spend, that's a headwind on margins for us this year. It'll likely be a headwind for us next year as well. And I would encourage you to look at things both ways. On a free cash flow basis, we think cloud is a great thing. And the longer we look at it, the more great it looks. CapEx actually was down year-over-year this quarter on infrastructure. And we're very pleased with what we see. And beyond that, I don't want to give too much guidance on 2018.

Operator

Our next question is from Ron Josey with JMP Securities.

Shweta R. Khajuria - *JMP Securities LLC, Research Division - Associate*

This is Shweta for Ron. Just a quick one on hotel negotiations. I believe there are a few upcoming or ongoing negotiations. Can you give us some update on that and how they're going and how it's changed over the past few years?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, we're -- I'm not going to characterize specific negotiations one way or the other, other than saying we've -- obviously, having the best hotel supply and the greatest breadth and depth of hotel supply is of real interest to us. At the same time, as we add more and more hotels and properties into our marketplace, the import of any single hotel or single brand grows less. So we feel pretty good about our position. And frankly, we feel good about our production for our partners. It continues to grow. We feel good about our share. We're becoming a more important part of our hotel partners' kind of portfolio and business on a global basis. And we will look to balance both margins and growth and supply, and we'll do so on a go-forward basis.

Operator

Our next question comes from Justin Patterson with Raymond James.

Justin Tyler Patterson - *Raymond James & Associates, Inc., Research Division - Internet Analyst*

First, it seems like alternative accommodations are gaining more momentum this year, and we're starting to see Google and metasearch businesses approach that opportunity. How are you thinking about customer acquisition in this environment? Are there any differences versus the hotel business? And then, secondly, looking more longer term, it seems like there's going to be a lot more cross-listing by property managers across HomeAway and some of the other alternative accommodation services. How are you thinking about adding on other services like attractions or restaurants and activities to really differentiate from more than just supply?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Sure. As far as the customer acquisition of alternative accommodations, listen, I think the formula is no different than the hotel formula or, frankly, any other travel product formula that we've established. And we've got some experience here. We've got some data here. So I think it's just applying the same formula. In general, searches for alternative accommodations, the number of searches are lower, let's say, for vacation rentals than for hotel terms. So the kind of availability for customers out there to acquire through variable channels is somewhat less. Sometimes, consumers don't really know about the category. I think consumers are becoming more aware of the category. But we think that even a consumer who, for example, was looking for a hotel in Orlando and has a family with them will be delighted at the kind of inventory that HomeAway has available, certainly, on a price-per-head basis, have a living room, et cetera. So I think for us, as far as customer acquisition goes, the formula will remain the same. I think what we bring to the pie which is different is that we are also able to take customers who are looking for lodging or are looking for hotels, and then introduce them to the alternative accommodation segment. And when we look at our Net Promoter Score for HomeAway users and people who experience alternative accommodations, it is superb. It is over 70. So this is -- it's our highest NPS-scoring product, and we will continually kind of test and learn ways of introducing this product to our consumers on a global basis because they are certainly delighted with it and certainly love it. For background, we are -- on a direct basis, we are investing very aggressively in sales and marketing at HomeAway. It's up 45% on a year-on-year basis. So we'll continue to be aggressive both on a direct basis and on an indirect basis.

As far as long-term goes, adding on other services, attractions, restaurants, et cetera, one of our core strengths is that we are multiproduct. And attractions is a large and growing part of our portfolio. We are building a database of everything travel everywhere. And we are building an engine to be able to combine all of these different products to delight travelers, we think, in a way and with capability that others are not. So I can't tell you exactly what the business is going to look like 3, 4, 5 years from now. But I do think that the customer interaction points are going to increase. Our relevance with our customers is going to increase, and I think we have a competitive advantage there versus the other players in the field.

Operator

Mark May from Citi.

Mark Alan May - *Citigroup Inc, Research Division - Director and Senior Analyst*

In terms of the comments around HomeAway international expansion, maybe you don't want to make too much of a deal out of this, but was this factored in when you last kind of spoke to and provided the $350 million EBITDA target for next year? Or is this kind of a change or new thinking here? And then in terms of the comments about ramping the hotel acquisition team, wondering if you could talk a little bit more specifically about where you see the opportunities there.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

So as far as international expansion, listen, the life -- with the speed of change in this industry, the opportunities available to us have changed very significantly since we first put the $350 million target out there. International expansion was certainly a consideration. But as we look at the business on a holistic basis, the target is the target, and the target remains on the table. Mark, do you want to talk about ramping hotel acquisition?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes, I think I'll use a similar answer to what I did before in terms of where the opportunity is. I mean, we view the opportunity as really everywhere. We feel good about our supply coverage in the U.S. and Canada. We've got significant opportunity outside of that. You look at Europe specifically, we think we can add multiples of properties from what we've got there right now. As you move further away from Bellevue, Washington, the opportunities only get bigger, Asia, Latin America. So I think at the end of all of this, I think we want to ultimately wire up all of the hotels and alternative accommodations that exist in the world. And there's a long road ahead of us to get there. But really, virtually every region has opportunity for us, and we'll get there in a metered way, in a way that delivers the best returns for our shareholders.

Operator

From Brian Nowak with Morgan Stanley.

Brian Thomas Nowak - *Morgan Stanley, Research Division - Research Analyst*

I have 2. The first one on -- you've been very good at ironing out inefficiencies in the system from cloud and other areas the last year or so. I was wondering, could you just talk to other areas you still see for potential efficiency improvement in the way you operate just to give you further potential leverage or the ability to invest harder? And then the second one on HomeAway. Can you just talk to kind of where you are in the evolution of pushing out HomeAway paid search or potentially more advertising investment further?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Sure. So on efficiencies, we see them across the business. We're very focused on delivering on a financial profile that allows us to essentially contain fixed costs, get good leverage on costs and basically flow the capital on the P&L to expansion-type investments, whether it's technology headcount, sales and marketing headcount or to sign up more hotels or direct sales and marketing. So that's essentially the formula. We continue to see a huge amount of opportunity in our call centers, and they have done just an exceptional job over the year of just getting more and more and more efficient, both in terms of handling calls, but then also rooting out the ways that -- or the reasons why people call and trying to solve those problems online. We've become exceptionally good at squeezing out fraud of all types out of the system. And I think we've become best in class in that standpoint. We continue to work very hard in our back-office operations and the way that we collect money and the way that we disburse money. We are collecting and disbursing through the merchant model over $50 billion on an annualized basis. And there's a lot of just automation that we're building into the system that we're going to continue to do, and we'll continue to allow that to scale. I think also, just in terms of the other parts of our operation, I think we're getting better and better at automation in general, both in terms of online marketing, some of the decisioning we do around where sales forces spend their time, is ultimately done by, in many cases, algorithms using the latest in machine learning capabilities. And I think it's a long road ahead of us and we see lots of opportunities across the business. Do you want to talk about Away paid search?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Yes, definitely. I would say on Away, listen, we are building up our talent in paid search. Conversion for us is, on HomeAway, clearly a tailwind for acquisition and marketing as it relates to HomeAway. That said, we're in the early innings. I would say that, that team has really started to operate in a real way for a couple of quarters. And I think we see very, very significant upside in paid search even though paid search volumes are increasing on a year-on-year basis. So it is early, and we expect much more potential from that team. I think just to add a little bit to what Mark said as far as the efficiencies go. One of the interesting, I would say, new occurrences that we're seeing at the company is that the way that we structure the company, as far as the technology platforms, are essentially separate. Every brand has its own platform, every brand or back-end group has its own CTO. But as we are building out our services based on newer architecture, some of these services become available to other brands to use. So we're actually seeing a lot more activity across brands. So for example, some of the HomeAway team is using some search that's been -- some search technology that's been developed on the Expedia side. And now we're seeing kind of tech teams sharing and consuming micro-services that have actually been built out across the company in other parts of the company. And rather than having to build out these services on -- kind of within each brand, the brands are sharing. And I think that will, long term, add to even more, call it, efficiency or more throughput on the technology side. And we're just starting to see it happen. We're not forcing it. But I think now, the CTOs are kind of building closer relationships. They're happy to take advantage of the labor of the other tech teams.

Operator

Kevin Kopelman with Cowen.

Kevin Campbell Kopelman - *Cowen and Company, LLC, Research Division - Director and Senior Research Analyst*

Can you give us an update on the air business? That's still a big bookings driver. Just what are the kind of key drivers you're seeing there? The tickets growth was a little bit slower. And then -- and what's the outlook in the air business?

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Yes, so we continue to be happy with the progress on the air business. The air numbers this quarter were impacted by a number of factors that caused us a bit of a slowdown from prior period. Generally, these are things that we're not concerned about at all. One of the big factors was Brand Expedia in Europe, testing with pricing and various online marketing channels and looking for profit optimization opportunities, so kind of regular course things. But we continue to be big believers in the air business, particularly as it relates to Brand Expedia. It's a key differentiator for us. The teams are getting better and better and better at using the air business as a customer acquisition channel for hotel and for other products. We continue to expand our -- the number of airlines, for example, that we're offering around the world. And we think it's a real key part of the formula. I think the other thing that's interesting that's happening in air is that as the airlines start to actually develop different fare types, as they start to develop different ancillaries, et cetera, it just gives more opportunity for leading tech players like ourselves to merchandise those and actually create win-win situations for both the airlines and ourselves. And we think that's just an absolutely great development. And I think in the -- back to the baseball analogy, I think we're in our early innings on that, and we think it'll be a long, fruitful path for us to work really closely with our airline partners to innovate over a long period to come.

Operator

It looks like we have no further questions at this time. So I'd like to turn the call back over to our speakers for closing remarks.

Alan Pickerill - *Expedia, Inc. - SVP, Treasurer and Head of Investor Relations*

Thanks so much. Dara, any closing?

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Just thank you again to the ever-expanding employee base across the company and another welcome to the SilverRail team and also a welcome of sorts to the Traveloka team to the Expedia family. It's great to have you guys onboard. So thank you very much for joining the Q2 call. And Alan, anything to add?

Alan Pickerill - *Expedia, Inc. - SVP, Treasurer and Head of Investor Relations*

The replay will be up shortly. Thanks, everybody. We'll talk to you next quarter.

Dara Khosrowshahi - *Expedia, Inc. - CEO, President, Director and President of Expedia Worldwide*

Thanks.

Mark D. Okerstrom - *Expedia, Inc. - CFO and EVP of Operations*

Thank you.

Operator

Once again, that does conclude today's call. Thank you for your participation.
