Manager thinking

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Lyrical Asset Management
Manager of the Curate Global Value Equity Fund

The Lyrical investment process: Looking at Expedia

Cheap stocks have historically delivered exceptional returns. By simply investing in the cheapest 20% of shares in the MSCI World Index over the past four decades, you would have beaten the benchmark by more than five percentage points per year.

However, while cheap stocks have been strong performers, the companies themselves are usually junk: low quality with slow earnings growth. In other words, they are good stocks, but bad companies.

We have discovered that buried within the junk of the cheapest stocks are rare exceptions of good companies valued as cheaply as the bad. Often, they look similar to bad companies, and so the market simply prices them the same way.

Our research process seeks to identify those rare exceptions. We call them the gems amid the junk. They are quality companies delivering strong earnings growth yet are ignored by the market.

To be a gem amid the junk, we require three traits: Value, Quality, and Analysability. Value is the fuel for our returns. Quality means that a company must have a competitive moat and can deliver consistent double-digit returns on invested capital (ROIC). Analysability means that a company is predictable enough for us to model out its long-term cashflows.

In January 2023, Expedia appeared on our screen of the cheapest stocks. It was trading at 11 times price/earnings, or a 40% discount to the MSCI World Index. Our initial review of Expedia found this was a high-margin, capital-light business with 50%+ ROIC, operating in a growing duopolistic industry. The company had grown its earnings per share at almost triple the rate of the MSCI World Index for the prior 15 years. On the surface, Expedia looked like a gem, and so we decided to dig in and research the business.

Our investment team began by learning everything we could about Expedia and its industry. We reviewed all relevant company and competitor filings, research notes, industry reports, and more.
For Expedia, we read more than 40 transcribed interviews with experts in the online travel agency industry. During this process, we look for the key investment questions that will make or break our thesis. In this case, one question stood above the others: why is Expedia losing market share to Booking.com?

For the next step of our research process, we tried to answer these key questions using all available resources. For example, we ultimately decided that Expedia's loss of market share was a long-term positive, as it would lead to higher long-term earnings power. That is because Expedia had been built up through more than 15 large acquisitions over the prior 15 years. These acquisitions had never been fully integrated, and so the company was burdened with duplicate costs.

Expedia was, however, in the process of de-emphasising its non-core brands. In the short term, this led to market share losses, but these were isolated to brands that weren't as profitable anyway. In the long term we concluded that this shift would significantly improve margins and competitiveness.

Answering key questions like this one helped us build confidence in our long-term earnings model. We also bolstered our confidence by stress-testing the business and balance sheet to ensure the company could withstand macro-economic pressure. Finally, we conducted a research review to address the remaining bear cases and compare the idea to other potential ideas.

Here was a stock trading at 11.7x earnings, with a wide moat and a clear path to growing earnings at a double-digit rate for the foreseeable future. Our portfolio managers voted unanimously to add the position to the portfolio.

We see a significant upside in Expedia, driven by its attractive earnings growth and deserved improvement in its valuation multiple. In other words, there are two drivers for the share price to move higher.

While earnings growth is something we can forecast, it is impossible to tell when the multiple will improve. But our quality approach to value investing means we can afford to be patient. We believe Expedia will outgrow the market's earnings growth for years to come. If it does that, eventually it should return to its historical market multiple, and our investors will have made a great return.

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