Despegar.com 1Q18 earnings conference call transcript

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Brad Erickson, KeyBanc Capital Markets

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PRESENTATION

Operator:

Good morning and welcome to the Despegar First Quarter 2018 Earnings Call. A slide presentation is accompanying today's webcast, which is available in the Investors section of the company's website, www.investor.despegar.com. [Operator Instructions]

Now I would like to turn the call over to Ms. Ines Lanusse, Investor Relations. Please go ahead.

Inés Lanusse:

Good morning, everyone, and thanks for joining us today for a discussion of our first quarter 2018 results. In addition to reporting financial results in accordance with U.S. generally accepted accounting principles, we'll discuss certain non-GAAP financial measures. Investors are encouraged to review the reconciliation of these nonGAAP financial results, which can be found in the press release.

I would now like to turn the call over to our CEO, Damián Scokin.

Damián Scokin:

Thank you, Ines. Let me add my welcome to all of you on the call today. We appreciate you taking time to join us. I will begin by providing my thoughts on the industry, review the highlights of our first quarter, and then discuss the progress on our strategic initiatives. Mike will then go over our financial results in more detail and review our outlook, after which we will open up the call to your questions.

Let me start by discussing the overall competitive environment. The LatAm travel industry showed solid growth in the first quarter of 2018, although not growing as fast as early 2017. As we have discussed in prior calls, we have been strategically focused on reinforcing our position in the marketplace as the leading online travel agency in Latin America. And we are willing to invest our margin to grow our market share and expand our scale, which we believe leads to a virtuous cycle that creates many benefits, such as better supplier terms, improved products, cost leverage, customer retention, and even the ability to attract the best employees.

Well, recently, we are seeing increased levels of competition from other online travel agencies, as well as some airline suppliers. We are confident in our value proposition to our customer, as well as to our suppliers. The airline industry remains very fragmented and depend on the indirect distribution of travel agencies in our region.

The investments we have made and continue to make in our technology platform, financing alternatives, and our brand help facilitate efficient customer acquisition for our partners. While these investments have put short-term pressures on margins and profitability, we recognize the need to continuously evolve and increase our relevance with our customers and suppliers.

We are competing to win in the long term. We have the capital and expertise to grow our market share and provide meaningful value to our stakeholders. Our strategy is consistent. We will continue to leverage our strength in the Air business to attract and convert customers to our higher-margin hotel and packages products, and prioritize investments in our mobile business.

Moving on, I am pleased to report on the progress we have made during the quarter to build brand awareness and drive new innovation on our technology platform. Before diving into our results, I'd like to take a step back to underscore our approach for the long-term value creation.

Our focus on cost management and efficiency has provided us some operating leverage in some areas of the business that we are using to reinvest in lower fees, more marketing, and customer financing to drive conversion. We are making smart strategic investments that are impacting our margins in the short term, but that we believe will solidify our position as the leading online travel agency in Latin America.

Now for some highlights on page 3. Overall, we performed well on all key metrics for the quarter and delivered solid results, despite a more competitive environment. We are driving growth with product and service innovation, expanded distribution, and increased brand marketing support along with pricing actions.

More specifically, our result in the quarter benefited from an increase in marketing, a reduction in fees, the Easter shift to Q1 from Q2 last year, and our focus on driving higher-margin Packages, Hotels and Other Products sales. This in turn enable us to deliver double-digit growth in all key operating and financial metrics, balancing growth and profitability. I will discuss the operating highlights and Mike will discuss the financial details in his remarks.

Now onto the key operating metrics. Starting with transactions, which increased 18% in the quarter to 2.5 million, reflecting growth from both new and repeat customers. Gross bookings were up 21% to $1.2 billion. This good performance was supported by a strong performance in Packages, Hotels, and Other Travel Products transactions, up 30% year-over-year in the quarter.

Let me know talk about mobile. This is a critical initiative for us, as mobile continues to be an important device for our customers and is the fastest growing channel for us. In fact, one-third of our sales came from mobile devices in the first quarter of 2018. This is 400 basis points higher than the same period of the previous year.

Our mobile first approach is also working to drive sales, with mobile transactions up 37% year-over-year. We expect mobile to continue growing, as our mobile app has grown in reach and has removed the complexity from the booking process. Reflective of this is the 41-plus million cumulative downloads of our mobile app since its launch. We have a significant opportunity to strengthen existing relationships and forge new ones with customers to an improved omni-channel experience, and mobile is key to this.

Let's move to slide 4, I would like to spend a few minutes providing some color on the progress we are making in driving growth in one of our key initiatives. We continue to see success in driving customers to purchase a bundled package versus just air tickets alone. Two key initiatives are propelling this.

First, the selected reduction in air fees, which we first implemented in the third quarter of 2017 and continued through the first quarter of this year. Second, we improved our customer financial offerings in a significant way. In turn, we saw 30% year-on-year increase in the quarter for Packages, Hotels and Other Products transactions well above the 9% growth in Air transactions. These higher margin products accounted for 59% of revenue in the quarter, almost 600 basis points higher than the same period in the prior year. Clearly, this strategy is working for us.

Gross bookings up 21%, continue to grow at a faster pace than transactions, reflecting the success of our strategy to drive mix shift to higher average selling price products, such as packages. As a reminder, as customer purchase bundled packages, there may be fewer transactions. Additionally, we saw an increase in the average selling price of stand-alone air and hotel transactions during the quarter.

Moving to slide 5, over the past several quarters, we have been working on a number of initiatives to become more responsive to how customers want to book travel with us. You can see several of them listed on slide 5, and I will touch on a few of them. All of these are indicative of the types of efforts that we will continue to launch as we seek to elevate our level of products and services and drive growth. We continue to identify opportunities to drive consumer engagement, [ph] take an (00:10:19) interest in our company, and encourage travel booking.

For example, in Q1, we once again partnered with Mercado Libre, Latin America's largest online marketplace, for the Si!week promotion. This is a one week online promotion with both companies offering attractive discounts. For us, it's an opportunity to increase sales, as the promotion also appeals to the impulse traveler. We were offering discounts of up to 60% for select hotels, car rental, as well as financing options of up to 21 months to pay with no interest. The Si!week promotion was available in Argentina, Brazil, and Chile.

Another initiative I want to mention is capturing customer demand through our call centers. Recently, including in Q1, we launched sales call center in Peru, Ecuador, Mexico, and also Colombia. While our focus remains online and mobile, in an omni-channel world, we need to be available wherever our customers want to book travel. Only one-third of customer travel demand in Latin America is online.

We want to also meet the needs of customers who prefer to book over the phone. As a result, we have launched the ability to accept phone bookings for select products, namely packages and hotels. Of course, we continue to take post-sales customer service calls via the call centers and are investing to improve our quality of customer service.

One last comment about mobile and customer service. During the quarter, we launched a service button on the mobile app, which enables travelers to reach Despegar, no matter where they are, via VoIP or Wi-Fi at no cost for them. The button is very intuitive and easy to reach.

As a company, we look forward to the opportunities ahead as we continue to execute on our strategic initiatives to maximize long-term potential for Despegar. I remain confident that our strategy of providing consumers with value and convenience, combined with the investments we're making to improve the booking and customer experience, should continue to position us to expand our market share and improve our financial returns over time.

I will now turn the call over to Mike to discuss the first quarter of 2018 financials.

Michael Doyle:

Thank you, Damián, and thank you, all, for joining us today. Turning to slide 6, I will start by reviewing our operations by region. We continue to gain overall market share despite increased competition in the region. Brazil, which is our largest market by transactions, achieved good performance by driving growth of higher margin packages and hotels, which was mitigated by slower growth in the lower margin Air segment, which has historically represented a large share of transactions.

Nevertheless, overall transactions in Brazil increased by a solid 14%. Transactions were up 21% in Argentina, beating market growth despite increased competition in Air and up 29% in Mexico, led by solid growth in packages and hotels, and some benefit from the launch of our call center in the first quarter. Columbia in turn remains impacted by lower domestic traffic resulting from capacity adjustments by a leading air carrier.

Please turn to slide 7, as a reminder, as disclosed in our year-end 2017 earnings release, starting in the first quarter of 2018 we adopted a new accounting standard in connection with revenue recognition. By doing so, we are now reporting financial results in a manner consistent with how management analyzes and manages business performance.

Under the new standard, we are recognizing revenue from transactions such, as hotel bookings, at the time of which they are booked by our customers rather than at the checkout, which could fall in a separate quarter. We believe this results in a better alignment between gross bookings and transactions, which have always been reported on a booked basis, and revenue, revenue per transaction and revenue margin, which historically represented a mix between booked and a checked-out basis.

For comparison purposes, we are providing pro forma Q1 2017 figures adjusted to reflect the new revenue recognition criteria. We will not be restating 2017 results and there will not be any impact to cash flow.

Now moving on to the P&L, the year started on solid footing with revenues up 22% year-on-year reaching $149 million in the quarter. We continue to gain traction by increasing the share of higher margin Packages, Hotels and Other Travel Products, with this segment reaching 59% of total revenues, up from 53% a year ago. This quarter we continued to selectively reduce air fees in certain markets to drive market share gains and cross-sell higher margin products in an increasingly competitive environment.

While Air remains a core business to Despegar, this strategy resulted in a 2% decline in revenues per transaction in the Air segment, but importantly, has allowed us to drive higher sales of packages and increased the revenue per transaction in the Packages, Hotels and Other Travel Products segment by 4%. Overall, the mix shift of packages and hotels contributed to double-digit growth in overall transactions and resulted in a 13 basis point year-on-year increase in revenue margin to 12.1%.

Turning to slide 8, we have several marketing initiatives deployed to keep our brands in front of the consumers. First, as I just mentioned, we selectively reduced customer air fees to drive customer acquisition and to cross-sell higher-margin packages and hotels. Second, we continue to offer customers an attractive selection of customer financing and installment plans.

This quarter, we also had a higher mix of transactions, where we were the credit card merchant of record instead of the airline suppliers, which allows us to offer more attractive customer financing options. This is a key marketing tool in driving conversion. As a result of these investments, the cost of revenue in the quarter was up by almost 380 basis points to 29.4%. This brought gross profit up for the quarter 16% year-on-year, while gross margin contracted 378 basis point to 70.6%.

As a reminder, in Argentina, in Q2 last year the local banking industry underwent some changes, where some of the cost of customer financing plans began to be passed along to the merchants. We plan to remain aggressive on offering customers an attractive set of financing options, as this is a key competitive advantage for us. This quarter we also boosted our direct marketing efforts, with selling and marketing increasing 31% versus a year ago as we continued to invest in building brand awareness and gaining market share in an increasingly competitive environment.

We also saw higher level of offline branding investments from the competition, as well as an increase in cost per click in some of our paid performance channels. As a percentage of revenues, selling and marketing expenses rose 200 basis point to 31.3% compared to 29.6% in the year ago quarter, as we were more aggressive in driving hotel and package traffic.

Moving on to profitability on slide 10 (sic) [slide 9] (00:17:45). Adjusted EBITDA increased 10% year-on-year, driven by our strong top line performance. Our strategy to prioritize growth, however, negatively impacted the adjusted EBITDA margin by almost 200 basis points to 18.4%, as we made investments to further strengthen our market position.

Financial expenses for the quarter were lower year-on-year, as lower FX losses from currency fluctuations and higher interest income from the invested cash balances more than offset higher credit card receivable factoring expenses in Brazil as a result of the increased gross bookings and customer use of installments in that market.

Income taxes were up 70% year-on-year, as the effective tax rate increased with our improving profitability in some markets and the depletion of tax loss carryforwards in some countries. Finally, we generated approximately $14 million in operating cash flow compared with $18 million reported a year ago. While we reported a higher level of travel supplier payables, credit card receivables were up, reflecting higher sales volumes, increased incentives where the company was the credit card merchant of record to improve our customer financing alternatives, and the accumulation of credit card receivables in Brazil, in line with our currency hedging strategy. Cash flow was also impacted by an increase in VAT tax credits, as well as other tax credits related to a technology incentive program, and an increase in prepaid expenses to suppliers.

Moving on to slide 11 (sic) [slide 10] (00:19:11), we see attractive growth opportunities ahead in the online travel market across Latin America, driven by a positive economic backdrop and ongoing migration from offline to online channels. The competitive environment has intensified across the region, while the currencies have devaluated in Argentina and Brazil. In this environment, we made the strategic decision to prioritize growth and are making the necessary investments to continue expanding our market share.

We remain confident in our long-term strategy, which reinforces our position as the leading OTA in Latin America. While Latin America, in general, is a more volatile region, particularly in terms of economic growth and FX, we have successfully been navigating these markets for close to two decades. While we are aware of the need to balance growth and investments with profitability, our focus on growth also means there could be a short-term impact to margins, particularly in the second quarter, traditionally our lowest margin quarter, as we continue deploying our marketing initiatives to build brand awareness.

We also remain focused on enhancing the customer experience, while continuing to pursue a mix shift towards higher-margin Packages, Hotels and Other Travel Products, and driving mobile transactions. We are encouraged by the growth opportunities ahead and we have an attractive value proposition and critical mass, along with a dedicated team, in place to execute on our vision.

That ends our prepared remarks. We'll be happy to take your questions. Operator, please open the lines for Q&A.

Operator:

Yes, thank you. We will now begin the question-and-answer session. [Operator Instructions] Today's first question comes from Eric Sheridan of UBS. Please go ahead.

Eric Sheridan:

Thanks so much for taking the question. One of the recurring themes among some of the global OTAs is optimizing marketing to drive more direct traffic to focus more on mobile. Wanted to know if we could get an update on your own efforts of examining your marketing spend, given the competitive environment, the goals you have around growth, the shift to packages and hotel, and how we should think about that marketing spend in some of the channels with relative ROIs and how it [ph] might change (00:21:37) over time. Thanks so much.

Damián Scokin:

Yes. Thank you, Eric. We constantly evaluate ROIs not only by channel, but on a cross-device basis also, because remember that we look at conversions not individually by channel independently. So just to give you an idea, today roughly two-thirds of our traffic is mobile. But as I said, we monitor our ROIs not only by that channel alone, but how much that investment in mobile traffic is helping us increase overall conversion.

So, going forward, my suggestion is not to look at that on an individual channel-by-channel basis, but overall. And that shift hasn't been the main driver behind our increasing marketing expense, but rather our commitment to continue sustaining higher growth rates in a not so fast-growing market as it was last year.

Eric Sheridan:

Great. Thank you.

Operator:

And our next question today comes from Mark May of Citi. Please go ahead.

Mark May:

Thank you. You mentioned increased competitiveness in the Air business that had an impact in the quarter. Can you talk a little bit about the packages side of the business? Are you seeing an uplift in competition in that segment of the market as well? And if not, is that something that you would expect maybe will build throughout the year?

And then secondly, you mentioned you're increasingly offering credit yourself as a merchant of record now that allows you to lower fees and offer more attractive pricing, but also has a negative impact on your gross margins. How far along are we in that? What portion of transactions are you the merchant of record? And how much further could that increase? Thanks.

Michael Doyle:

Mark, this is Mike. Let me take the second question first on merchant of record and credit extension. So we are increasingly using our merchant of record to avail ourselves more attractive customer installment, promotions, and offers from our banking partners, I want to be clear, though, that we're not actually extending the credit ourselves. All credit risk still is maintained by the banks. But we are basically exchanging being merchant of record for having a more compelling offering.

In the past, there was a larger mix of transactions, where the airline was the merchant of record and they had some of their own financing plans on offer. We find that the banks' promotions are more attractive to the customers and that's why we're willing to be merchant of record. With the product category where we've seen a mix shift occur is in Air for the reasons I just gave, that the banks promotions being more attractive than the airlines, and there is still room for that mix to shift. And our other products and packages and hotels, we're almost always the merchant of record already, so that there is not an increase there to come.

Regarding the competition, when we say that we've seen an accelerated or an increased level of competitive intensity, it's been largely on the marketing side, on offline brand investments and a bit less, but also existing in the online paid performance channels. It's not so targeted by products. We do see it across all product categories. And, of course, we believe our strongest value proposition is within the package product, where we have a differentiated offer versus a number of our competitors, but we did see competition increasing in marketing investments across all product categories in the quarter.

Mark May:

Thanks.

Operator:

And our next question comes from Brad Erickson of KeyBanc Capital Markets. Please go ahead.

Brad Erickson:

Hi. Just had a few follow-ups. I guess, first just on that comment you just made, Mike, on the rising competition. Are you meaning kind of – so you're implying other meta or OTA players you're seeing more competitive front, or are you talking direct booking to some degree as well?

Mike Doyle:

No, we're talking about indirect, both meta and OTA, but haven't seen a significant change on the supplier side.

Brad Erickson:

Great. And then just related to the brand spend that you guys are taking up here, talk about how pervasive that is geographically, and then just how we should think about the linearity of those campaigns through the year? And maybe if you could call out what you spent specifically on brand marketing in the quarter, that would be great.

Mike Doyle:

Sure. So our offline brand spend remains about a third or less than a third of our total marketing investments. That was true in the quarter and that's how we're planning the remainder of the year as well. We invest in brand building across all of our key markets and saw an increase in spend from the competition in all of our top three in Argentina, Brazil, and in Mexico. That was true. And the meta-search players investing more, particularly offline, as well as some of the global players in both the hotel and vacation rentals.

Brad Erickson:

Got it. And then just related to packages, can you talk about how much the opaquely priced products are contributing to that growth, if at all?

Damián Scokin:

Yeah. We do not the disclose specific components in terms of price for the packages. But having said that, it's, obviously, a key part of our ability to offer better rates to our customers. So we're intensely working with that and the share of our peg (inaudible) rates in, I would say, the overall tickets we sell through packages is growing

Brad Erickson:

Right. I guess, my question is really just, is it contributing materially to the growth or is that still just really getting going and very, very small?

Damián Scokin:

No, no. The growth we are seeing in packages is, obviously, a result of many actions. Better negotiations with hotels, but also the availability we have on better rates from else. So it's a key component of the growth we are seeing in packages.

Brad Erickson:

Got it. And then finally just related to currency in Argentina, what have you seen both in terms of demand? And I'm assuming suppliers have adjusted prices at this point, but just wondering how has that been trending through Q2 so far. Thanks.

Damián Scokin:

Yeah. Regarding Argentina, two things. First, overall demand. When this type of turbulence occurs and we've seen many in the past, the initial reaction of the consumers is to contract their spending and we're seeing that. But as soon as the market stabilizes, consumers come back. And in most of the cases, they catch up on the lagged demand. As per suppliers, in terms of domestic, we haven't seen an uptick in prices yet. As per international [ph] fees (00:29:37), you know that most of them are dollar-denominated, so there is a natural hedge there.

Brad Erickson:

Got it. Thank you.

Operator:

And our next question comes from Brian Norwalk of Morgan Stanley. Please go ahead.

Brian Nowak:

Thanks for taking my questions. I appreciate all the color on the competition. I know you guys analyze a lot of data and sort of assess the environment. Just trying to better understand on the competitive front, are you seeing an impact to your traffic or to your conversion rates or some combination of both? And then as a follow-up, how do you think about the need or it depends on strategy to reduce consumer fees in order to grow faster and compete harder? Thanks.

Damián Scokin:

Hi, Brian, this is Damián. In terms of the competition, we are seeing the effect not so much on conversion rates, which continue to grow, but more in the fight for traffic. That's where we are seeing the presence of other OTAs in a higher degree. So there we've seen competitors spending more money in marketing. Remind me the second part of your question, sorry?

Brian Nowak

The consumer fees and how you think about reducing the consumer fees?

Damián Scokin:

Wonderful, yeah. As we always mentioned, we manage consumer fees very country by country and situation by situation. We have algorithms that even track on destination basis. So we don't have, we believe, a single common approach across all markets, all destinations, and all services is not the best way to go. So if you ask me what's your overall policy on fees, there is no overall policy.

Getting to the specifics on your question, there are some markets and some destinations in which we charge zero fee. We've been doing that for a while. And there are other markets, other destinations, other segments in which we charge a lot of fees. And that's the, we believe, part of our unique approach to this. So where we see that the elasticity of reducing fees or even taking out fees is the best, we go for that. And when we can charge, with even improving our bottom line, we do that.

Brian Nowak:

Okay. Thanks.

Operator:

Today's next question comes from Kevin Kopelman of Cowen & Company. Please go ahead.

Emily DiNovo:

Hi. This is actually Emily on for Kevin. I was just wondering if you could give us more detail on the currency impact in the quarter. And secondly, how should be thinking about EBITDA dollars for this year and next? Thanks.

Michael Doyle:

Emily, this is Mike. On FX in quarter, as Damián mentioned, the first impact is for customers to observe what's happening and take a view on whether they want to accelerate or delay their purchases. Really, what we observed is that customers respond negatively to volatility and uncertainty, but do adjust pretty quickly to a devalued or any new stable rates of exchange. In the first quarter, the rate of change in the FX rates was less than what we've seen at least in Argentina in Q2 quarter-to-date. So we had less of an impact – or observed less of an impact on demand.

In fact, there are several impacts in the P&L from FX and one important one to mention is that we have our largest installed base fixed cost in Argentina, where we're headquartered, and so there is some cost savings impact in the quarter. Now headed into – or in Q2, whether there's been an increase in volatility in FX, what we want to have to balance that with is the benefit from cost savings and then any headwind from a reduction in demand. So that's really what we're looking at.

We haven't shared the results on a constant-currency basis, because so much of our business is outbound from our points of sale. For example, in Argentina only about 30% of the business is domestic. And so a big portion of the transactions are really supplier priced in terms of dollars. But on a local currency basis, our rate of growth probably be about 10 percentage points higher than what we are reporting in U.S. dollar terms. But importantly, we think it's – we measure the business in dollar terms and measure our performance in growing volume and taking share. I think those are most important areas for investors to monitor as well.

Emily DiNovo:

Great. That was very helpful. Thanks.

Operator:

As there are no more questions at the present time, I would like to return the call to Damián Scokin for any closing remarks.

Damián Scokin:

Yeah, thank you. I would like to reiterate two points. First, Despegar is competing to win in the long term. We have the capital, the expertise, to invest our margin is necessary to continue growing our market share, provide meaningful value to our customers and suppliers. And we believe we are very well-positioned at the competition to do that. Our strategy remains unchanged even in this less favorable market conditions. We will continue to leverage the strength of our Air business to attract and convert customers to our higher-margin hotels and packages products. And we will continue to prioritize our mobile business.

Our long-term financial objectives are also unchanged. We believe our ability to offer a compelling travel booking experience in all channels is what the customer values. And we are optimistic about our prospects to achieve sustainable and profitable growth over the long run. Thank you all for joining the call today, and we look forward to speaking to you again the next quarter.

Operator:

Thank you. The conference call has concluded. Thank you for attending today's presentation. You may now disconnect.