Citron RESEARCH

Sept 20, 2013

Citron Presents the Most Comprehensive and Thoughtful Piece on Zillow Ever Published. This is why this stock is going to $80 … then $50 … then right back to where it started the year … $30 per share.

Everyone knows Zillow(NASDAQ:Z) is overpriced … but who cares??

The pivotal question every investor needs to ask is simple, but crucial:

"Are Zillow's Best Days Ahead of it, or Behind it?"

If its best days are still in front of them, patient shareholders could reap even more rewards. But if the future is nothing more than a mirror of the past … watch out below!!!

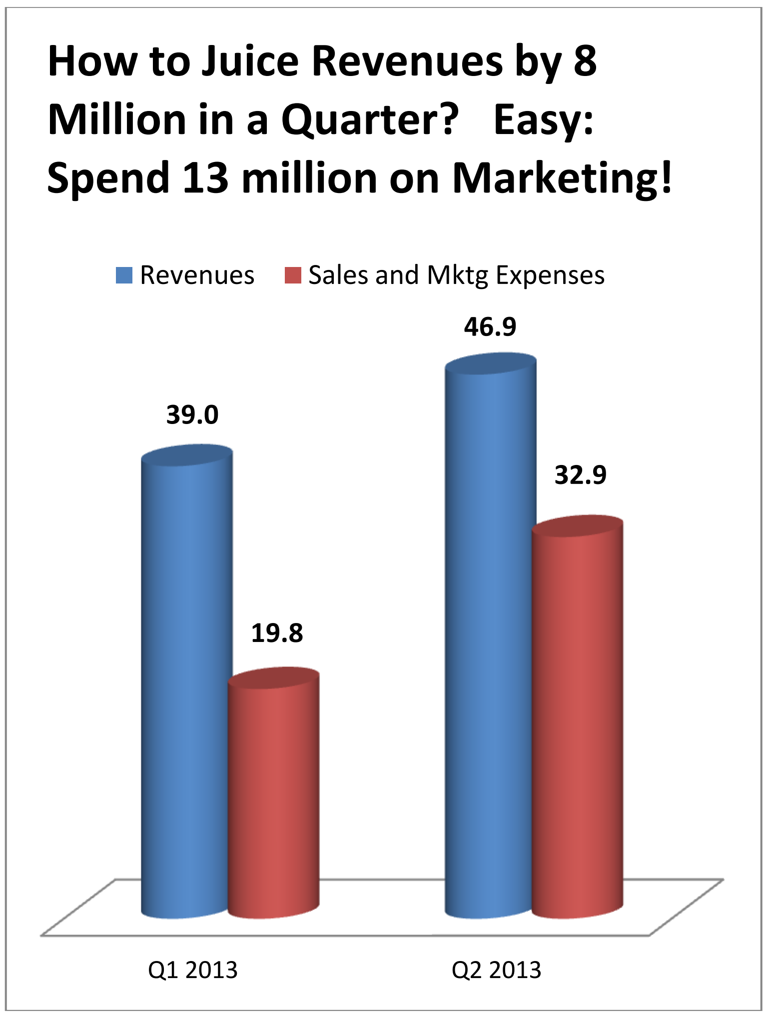
Instead of focusing on the past, this piece will look into the future of Zillow. More importantly, Citron will expose the disturbing trends beneath this online real estate "Brand recognition", and why the future does not look any brighter and how Wall Street has become completely blind to the obvious signs.

We are not going to rehash the premise that we presented year, regarding their lack of appeal among their customer base, or their precarious position in the US residential real estate market. Since our initial report, the stock has gone from $42 down to $25 to now $95 all while the financials have deteriorated but the rhetoric is at an all time high.

Before we go into detail about the future, we must touch on the present.

Most Recent Quarter: Complete Disaster -- No Other Way to Look At It

Beyond all the hyperbole and headlines that read “”Record this…” and “Record that… ” it’s still supposed to be a business. The below chart shows all you have to know about last quarter.



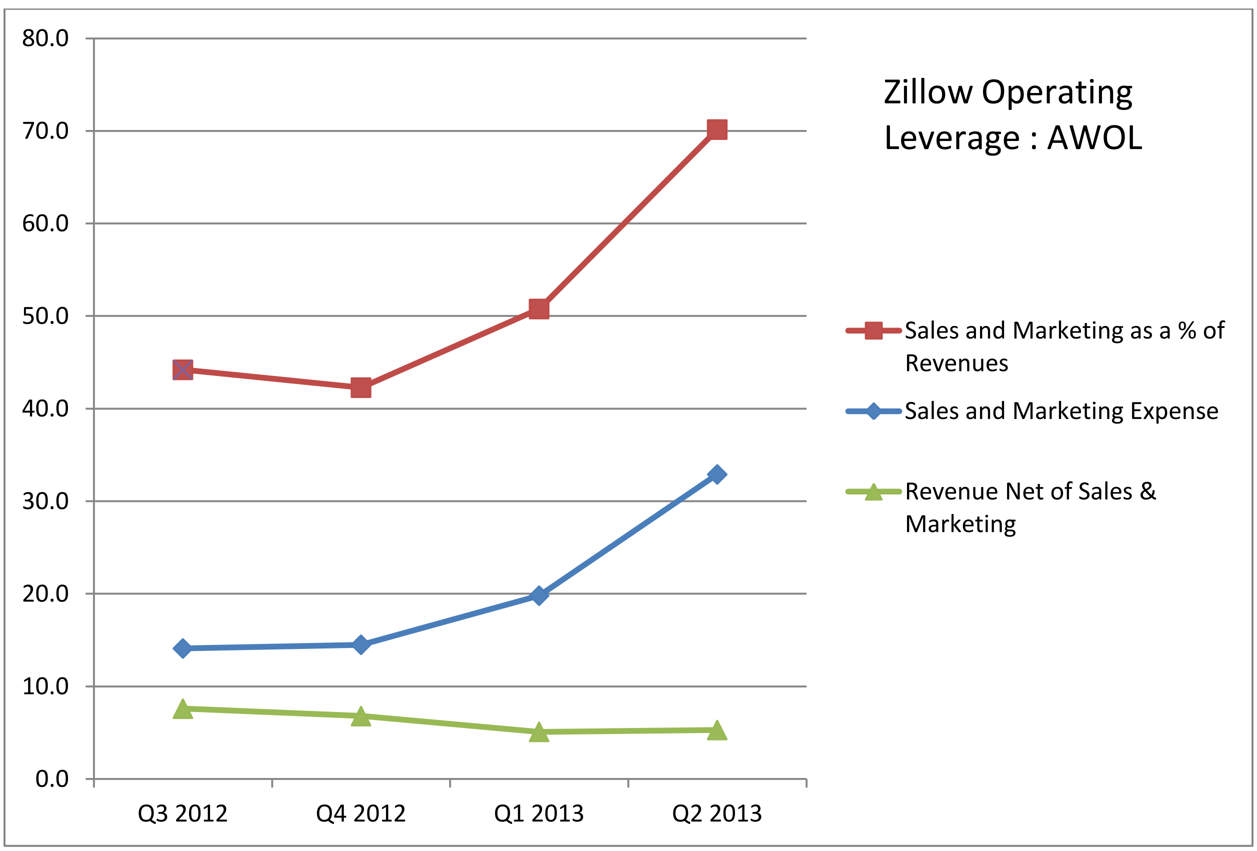
Beyond missing estimates, Zillow spent more getting revenue than the revenue itself. Is this a business? Rascoff recently told the investors that housing has experienced a string of price increases spanning 17 consecutive months , yet this is what Zillow's business model looks like in the best of times? This quarter's results demonstrate neither scalability nor efficiency.

No one on Wall Street has ever been able to rattle off the case for his company more eloquently and rapidly than CEO Rascoff. He reminds us that there is a potential $6 billion "revenue pie" – the money realtors spend on advertising – and Zillow now garners only a smidgen of that. Think of the potential!

Even though the Zillow CEO talks about the huge percentage of total Real Estate marketing that Zillow doesn't attract, there is so much wrong with this thinking. To expose this, ask yourself "what happened to all of the spending on classified ads, music, and travel agents?" Sometimes the internet just makes money flows disappear, and not transfer to a new collector.

Zillow's revenue **does not** come from advertising homes ... it comes from agents paying for leads to get buyers and sellers. The advertising of homes is free on multiple sites, with no barrier to entry.

The backside of these disturbing trends can be clearly seen in their last earnings report, in which they reported dramatically decreased margins. We see that their revenue, net of sales and marketing, is almost at an all time low:



The simple fact is that rapid-growth tech companies like Google (GOOG), Facebook (FB), OpenTable (OPEN), and LinkedIn (LNKD), all have something Zillow lacks: a high degree of operating leverage. And they lack something Zillow depends on: television commercials and a huge phone telesales room.

Zillow fills no such compelling need; thus its revenue growth is obtained only with expenditures of more than 100% of that expanded revenue in ads and telesales. It has been around for seven years, operating the same business model, and it has not made a meaningful profit over that timespan. Citron doesn't see that changing any time soon.

All the while, whenever given the opportunity Rascoff compares his company to LinkedIn. He has actually said it so many times that he even got the Jim Cramer to put it in the same breath as LinkedIn. Well, people lie, numbers do not lie. This is what the past 4 quarters have looked like for LinkedIn vs Zillow.

	LinkedIn				**Zillow**			
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2012	Q4 2012	Q1 2013	Q2 2013
% of Revenues spent on Sales and Marketing	33.0%	33.0%	33.7%	33.6%	44.2%	42.3%	**50.8%**	**70.1%**
Adjusted EBITDA	56.0	78.6	83.1	88.6	7.6	6.8	5.1	5.3
EBITDA as a % of Revenues	22.00%	26.00%	26.00%	24.00%	24.00%	20.00%	13.00%	11.00%

	Reasonable, predictable percentage of revenues spent on Sales and Marketing	Something else entirely!
	Growing EBITDA	Shrinking EBITDA
	Proven scaleable, responsible and predictable business model	Demonstrated ability to manipulate Wall Street!

The Myth of Mindshare

When asked about the quarter, management justifies its increased marketing spend by saying they are gaining Mindshare. In a scene out of 1999, we are supposed to be wowed by clicks and visitors without discussing the obvious:

None of this traffic is monetizable.

Zillow is #52 in Alexa's "Most Visited Site" list (#53 and #56 are actual porn sites….check for yourself on Alexa.) As a Wall Street Journal article mused on Zillow, "It is a lot easier to buy clicks than to buy profits."

It's "Real Estate Porn"

It's really critical to understand that Zillow is referred to in many a media outlet as nothing more than "Real Estate Porn". When the Zestimate was unique, it was the only way for voyeurs to see a quick and dirty estimated price of their own house … and their neighbor's. That moat is now gone, as every real estate listing site now has an estimate tool.

Note that, like most "adult sites", **Zillow doesn't own its content**. Yet, adult sites don't need expensive television commercials to maintain their spots on the popularity lists. The moral of the story, which was well discovered during the 2000 Nasdaq crash, is that internet traffic does not make a 4.0 billion dollar company. Traffic **can** translate into mindshare, but that **does not** translate into a viable business model.

Are You a Zillow Investor? Did you know this??

From all the ads, and the glowing pronouncements of Zillow's CEO on Twitter and at every chance the media gives him, you'd think he was dominating his space. Here is the single most shocking number in this entire report:

Zillow accounts for only 13.5% of all real estate web traffic.

That's right, barely **one out of eight** Real Estate web page displays are Zillow's….. the majority of Real Estate internet traffic it is dominated by individual realtor sites and local MLS listings … neither of which are going away.

With all of this bad news, it is no surprise we see insider selling … but to this extent?

Insider Selling

Zillow's management takes every conceivable opportunity to insist that it is "firing on all cylinders" . But at current run rates, it would take 35 years of EBITDA to catch up with the amount of insider selling! This is not insider selling-- this has become insider pounding.

Insiders have sold more in stock than the company has done in total revenue since IPO….Amazing

So now that we have established that the current state of Zillow is not what management makes it out to be, does the future look any better? NOT A CHANCE … IT'S MUCH WORSE.

Before we prove our points about the future of Zillow, we will let the numbers prove our point. The bulls will say that all of that bad news is in the first part of the report – it is just setting the company up for a better future…..NOT.

In a set of statistics that no doubt will one day be studied in MBA programs throughout the country when discussing market bubbles, let's look at what Zillow share price and earnings estimates have done this year.

Zillow	Beginning of 2013	Now	Pctg Change
Stock price	$28	$98	250%
2013 Consensus estimate	.48	.03	**-93.8%**
2014 Consensus estimate	1.07	.57	**-46.7%**
2015 Consensus estimate	1.47	1.23	**-16.3%**
2016 Consensus estimate	1.87	1.53	**-18.2%**

Again, since Zillow's Rascoff insists on comparing his company to LinkedIn, here's how LinkedIn compares:

LinkedIn	Beginning of 2013	Now	
Stock price	112	249	122.3%
2013 Consensus estimate	1.28	1.55	21.1%
2014 Consensus estimate	2.08	2.18	4.8%
2015 Consensus estimate	3.00	3.29	9.7%
2016 Consensus estimate	4.00	4.90	22.5%

The Customers Prove Citron's Theory

We start with the premise that 80% of the current revenue is from selling leads to real estate agents.

In the National Realtors Association 2012 Technology Survey Report we find that 75% of Realtors participate on Facebook, and 70% in LinkedIn.

86% say referrals and repeat business are by far the most important component of generating leads.

http://www.scribd.com/doc/142768056/Realtor-Technology-Survey-Report-2013-05

What is most interesting about this report, is that realtors and brokers consider Zillow, Realtor.com (MOVE.com) , and Trulia in the same basket, with no differentiation within the cohort. The reason this is important is because **real estate brokers are Zillow's primary customers.** While Zillow might claim to have mindshare of Internet visitors, it **does not** have the mindshare of of its own primary revenue-generator base.

Zillow's Most Important News of the Year: and it Went Completely Unnoticed by Wall Street Analysts

One of Zillow's biggest Achilles Heels has been the inaccuracy of their listing data. Somewhere between 17% and 19% of Zillow's listings aren't even listed for sale at any given time. Listing data is their lifeline to users – on this content rides their credibility; it is their lifeline to their users. http://www.inman.com/2013/03/06/accuracy-zillow-trulia-listing-data-under-fire-again/

Zillow's had a solution. They hired a MLS point man with over 30 years experience in the MLS business, to help Zillow forge key strategic relationships with the Realtors and their MLS organizations. When he hired on, the PR quote was, in fact:

“Bob’s deep industry knowledge will help Zillow engage with brokerages and MLSs in a mutually beneficial way as we bring expanded communication and cooperation to our current and potential partners”

-- Spencer Raskoff, comments on Bob Bemis joining Zillow…

But in late July, with less than a year on the job, **Mr. Bemis abruptly resigned.**

“I was frustrated with the lack of inroads we made in the MLS community.”
In discussing pushback from the industry, “Most MLSs didn’t see a great advantage in setting up direct data feeds”

-- Bob Bemis, upon his departure from Zillow…

http://www.inman.com/2013/07/31/zillows-point-man-with-mlss-brokers-departs/

What would happen if the head of Tesla battery technology said “we just can’t get a battery to power electric cars in the future”? Or more on point, what if the head of Netflix content said, “We just can’t find a way to acquire content from networks or studios.”?

This bad relationship with the MLS is most clearly shown in this one-minute video segment you **<u>must see for yourself!</u>**

(Click to play)

“we have no profits” … “you are trying to get water out of a stone”

-- Zillow CFO … pre IPO meeting with MLS leaders …

So Zillow is left with a company that will consistently disappoint on earnings as real estate information becomes open for everyone and real estate agents become more expert with social media and search engine optimization.

Social Media Killing Zillow!

Wall Street supporters and naysayers have spent hours and volumes analyzing and predicting the future of Zillow. Yet, the major flaw in the business and why it is getting worse can be described in 9 words? These 8 words could have been the content of this full report. They demonstrate why Zillow can never grow into this nosebleed multiple:

"Can you recommend a good real estate agent?"

Buying a home is the most momentous financial decision most Americans will ever make. The process is overlaid with substantial emotional stress as well as the obvious financial considerations. In the same decision, buyers and sellers are deciding where to raise their family, where their children will go to school, and where to put their assets.

The internet economy has become increasingly review and referral based. Trusting your network is important, paid sponsorship on websites has become transparent. The days of boiler rooms selling "top of page placement" in platinum and gold packages is a thing of the past….. it is sooooo 2003. But somehow, chatty CEO's like Spencer Rascoff can still convince Wall Street that this model is not only relevant, but compelling enough to run up huge deficit spending to chase it.

There is a reason why Facebook is $45 a share and Twitter just filed for an IPO. People trust people they know. Networking is important. Realtors know it and investors should know it as well.

What's with the Australians and Zillow?

Just last week we noticed another 13G filer from Australia on Zillow. This one is James Packer of the Australian media mogul Packer family. While we have great respect for the empire built by his father and the casino empire built by the younger Packer, we believe that Packer does not fully understand the Zillow dynamic for this one reason.

Many Australians would like to compare Zillow to the REA Group, the leading listing portal in Australia. There is a MAJOR difference to say the least. Australia does not have an MLS system and REA Group is the default search source for all homes in Australia. Their site accounts for 61% of all real estate searches in Australia and generates revenue from sellers advertising their properties. That is why REA group spends **12%** of revenue on sales and marketing, while Zillow spends over **70%.**

Buy side agents do not exist in Australia and typical real estate commission is 2%.

It is the opinion of Citron that Australians are mistakenly regarding Zillow (and Trulia in the case of the other major filer) as the US version of highly profitable and dominant REA Group. Unfortunately for them, this couldn't be further from the truth. Just because an apple is a fruit and an orange is a fruit they can still be as different as apples and oranges. The only question is when they figure this out – while they still have a big profit in the stock, or after it starts evaporating … or have they figured it out already?

If not the REA Group than what exactly is Zillow?

If you want to know what Zillow truly is, we refer to you a piece written a few months back on Glass Door from a former employee. This is what you get for your $4 billion.

"A Boiler Room by any other name, still smells as rotten..."

Inside Sales Consultant *(Former Employee) -- Irvine, CA*

I worked at Zillow full-time for less than a year

Pros – *Great benefits (Heath, Dental, 24 Hour Fitness membership- if I'd ever had time to go, stock options), plus "perks" to keep you perky like free espresso, coffee, Red Bull, Monster, sodas, and lunch catered once a week, plus once a month Happy Hours after work with apps and beer. Also, the company flew us to Seattle for the holiday party and put us up at the W hotel. A few of the top Inside Sales Consultants DO actually earn a 6-figure income, and even with your base pay and hitting just quota, you can make a decent income.*

Cons – *11-12 hours days with lunch breaks severely frowned upon. Basically, if you take lunch, it's nearly impossible to hit your "call time" of 210 min per day- That's time spent TALKING on the phone- not counting dialing, ringing, etc. Can you say micromanagement?? I loved my job at Zillow for the first 2-3 months I was there. I thought it was the best job ever. This seems to be the path of most Inside Sales Consultants. You are given praise and encouragement and low, manageable quotas during your 'ramping' period of your first 3 months. You literally "drink the Kool Aid" (or Red Bull, in this case) and think Zillow is the Best Place ever. Then Reality sets in, as does the stress, micromanagement, constant stream of emails about your talk time being too low. If you enjoy receiving 300 emails per day asking what you are going to sell, telling you to join the next of a never ending stream of call "blitzes," this may be the job for you. Still, I think 6-9 months seems to be the threshold for about 85% of people, hence the turnover rate. This is a HIGH burnout job. If you are looking at working for Zillow and not reading many reviews like this, consider this: I recently quit my position to take another job. Several people I that started in my training class have been let go. (Actually from my class of 18, only 3 now remain.) I recently learned that when they are let go for not meeting quota, they are offered a severance pay in return for signing an agreement to not post anything negative online about the company. It seems they are buying the silence of anyone who might say anything non-positive about working there. I signed no such agreement. Just thought you should know this if considering taking the position.*

http://www.glassdoor.com/Reviews/Employee-Review-Zillow-RVW2705892.htm

Conclusion

What is most amazing is that with this multiple and euphoria in the market, you would think that Zillow has something unique. But at the end of the day, they are a listing portal with nothing unique or proprietary they own. Yes, they have built a strong brand, and their $50 mil acquisition of Street Easy was impressive to Wall Street analysts, because it is so New York centric.

Yet, they operate a business without a moat. The Zestimate in no longer unique to them and they are nowhere with regard to becoming a leader in rentals or mortgage. Just read any real estate website and see the stream of news that comes out on the many competitors of Zillow. We know the truth, management obviously knows the truth (obvious through amount of insider selling) now you know the truth.