

## Zillow Group, Inc. (ZG)

### The digitization of real estate brings massive opportunity

#### Introduction:

Zillow is the largest online real estate platform in the US. It helps simplify property buying, selling, renting, and financing. Currently enjoying tailwinds (from one of the strongest US real estate markets in more than 14 years) Zillow has been consistently delivering impressive top and bottom-line growth in recent quarters. Additionally, Zillow has been aggressively investing to broaden its digital ecosystem (by exploring opportunities in additional markets such as “iBuying”) to become a 'One-Stop-Shop' for home buyers and sellers. Despite a strong financial outlook, the shares have corrected more than 50% from 52-week highs (in February 2021) making Zillow an attractive opportunity to consider now. In this report, we analyze Zillow's business model, competitive strengths, growth strategies/opportunities, profitability, financial position, and finally conclude with our opinion on investing.

#### Overview:

Founded in 2006, Zillow is an online real estate marketplace. The company's offerings improve and simplify the complex real estate buying, selling, renting, and financing experience for consumers. Zillow initially started as a digital platform allowing users to search and find properties (and generated revenue primarily from selling its ad inventory). Over the years, the company has transformed itself into a

#### Key Takeaways:

- Operates in a large industry with multiple adjacent market opportunities.
- Voluminous real estate insights coupled with machine learning capabilities position Zillow uniquely.
- Broad seller and buyer base creates a network effect moat.
- IMT segment protects the downside while the Homes segment provides significant upside potential for investors.
- Zillow has a robust balance sheet and liquidity position to support expansion initiatives.
- Attractively priced at current valuation.

'one-stop-shop' for the needs of real estate buyers and sellers. In Q2 2021, Zillow had 229 million average monthly unique users on its website (with 2.8 billion website visits). It has 135M+ homes on its platform across the US making it the largest online real estate platform in the country.

Zillow operates under three segments. First, through the **IMT segment**, Zillow offers various management and advertising solutions to real estate agents, brokers, and property managers through its website.

These solutions help agents generate leads and connect with buyers, manage and streamline the selling process and get data-driven insights. This is the company's oldest and most profitable business segment and accounts for 36% of its top-line.

Next, through its subsidiary *Zillow Offers*, Zillow is engaged in directly buying houses from sellers, making required improvements, and then selling them at a higher price, thereby generating profits. It started this business in April 2018 and is now the second-largest instant buying (iBuying) player after Opendoor (OPEN). Revenue from this business, along with Zillow's closing services business, come under Zillow's **Homes segment**. The Homes segment accounts for more than half of the company's top-line because the entire selling price of the purchased home is recognized as revenue, however, the segment is yet to reach profitability.

Zillow also provides home loans to property buyers under the segment '**Mortgages**', which also includes revenue from advertising sold to mortgage lenders. The segment accounts for only a 5% share of the revenue.

Segments	Revenue Mix	EBITDA Margin
Homes	59%	-4.3%
IMT	36%	46.2%
Mortgages	5%	0.4%

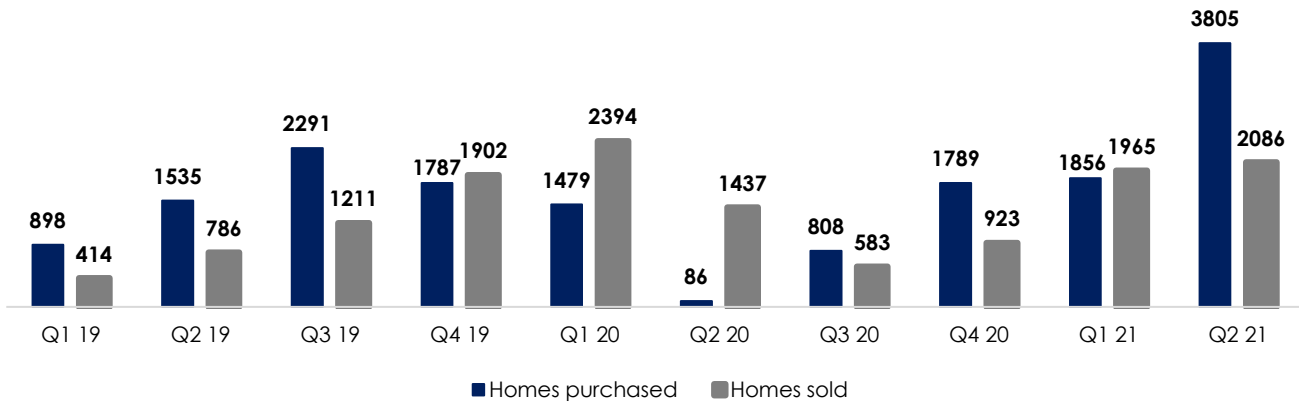
Source: Company's filings

The real estate industry saw a massive surge in trends following the pandemic. This primarily resulted from lower interest rates and 'The Great Reshuffling' which took place in the wake of the coronavirus pandemic that led to more people looking to shift to larger and affordable homes or switch cities due to a 'work from home' trend. The robust housing market led to a strong demand environment for real estate services providers such as Zillow.

## “iBuying” further expands Zillow’s market opportunity

Zillow's expansion into iBuying has significantly expanded its total addressable market. As per company's estimates, home transactions is a \$1.9T market opportunity based on the value of homes sold in 2019. Considering a conservative take rate of 5%, this translates into nearly a \$100B economic opportunity. After becoming the second largest player in iBuying, Zillow is now targeting to hit \$20B in annualized revenue in the next 3-5 years and has already doubled down on its efforts to expand into newer geographies and buy more homes. In Q2 2021, it purchased 3,805 homes which is significantly higher than previous quarters, and is planning to purchase 5,000 homes each month going forward. With Zillow rapidly becoming a household brand in the US, the company has multiple adjacent market opportunities which it can penetrate moving forward, such as, Renovation services, Home Insurance, and Moving services.

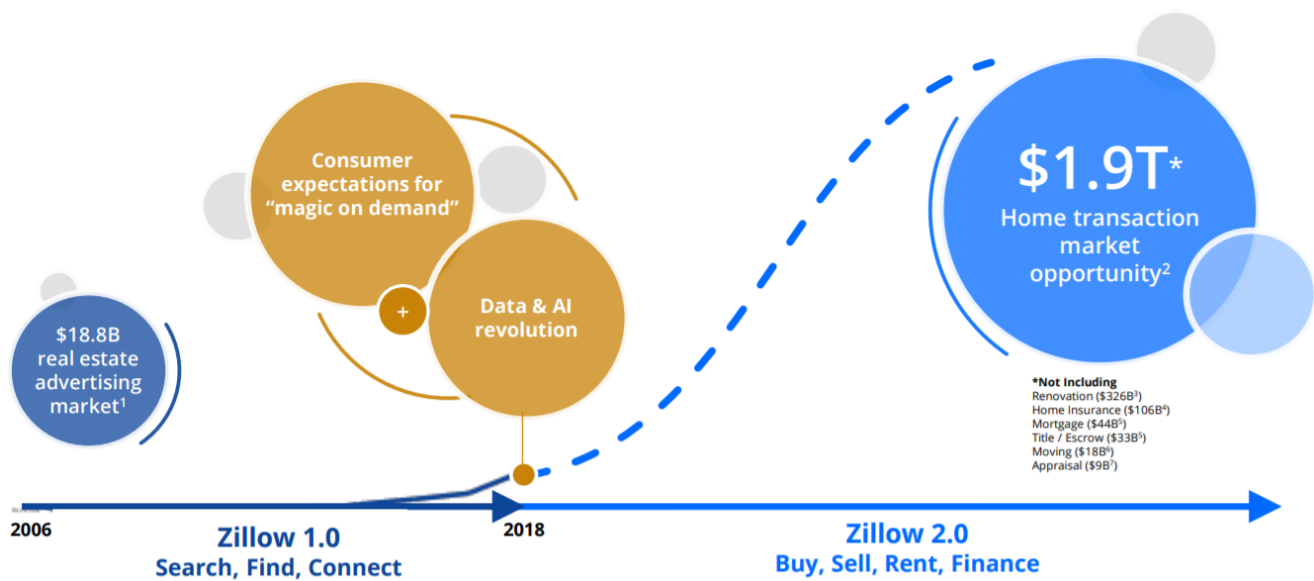
**Zillow home transactions**



Source: Company's filings

Additionally, Zillow (along with its portfolio of renowned brands such as Trulia, StreetEasy, and Hotpads) is a leader in the real estate advertising market that has much higher

margins. The market is estimated to be \$18.8B, indicating Zillow's market share of 10%. Additionally, closing services and the mortgage business is estimated to be \$33B and \$44B in target market sizes, respectively.



Source: [Zillow's Investor Deck 2020](#)

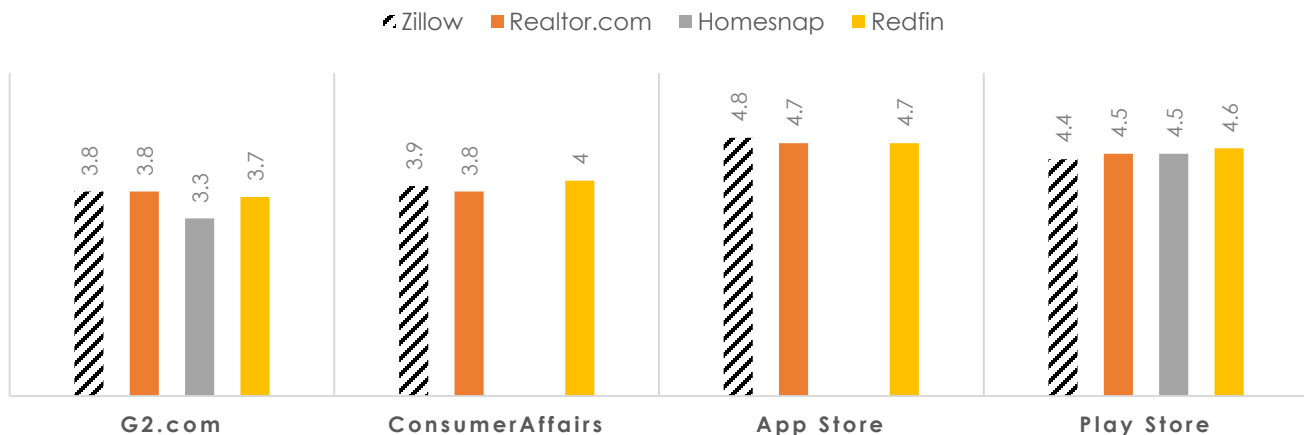
## Leadership position in a highly fragmented industry provides a competitive edge

Operating in a large and highly fragmented market, Zillow possesses a notable edge over traditional agents due to its massive scale and superior technological infrastructure. It can leverage vast amounts of data to get insights and make data-driven decisions. The broad, unified platform also leads to cost savings due to economies of scale, allowing the company to offer attractive pricing by sharing a part of savings with the customers in the iBuying segment to better compete with peers. Moreover, the digital buying experience provided by Zillow is far more convenient and quicker for sellers relative to

other traditional players. Capturing a larger market share from traditional players in this vast real estate market alone offers ample room for expansion for Zillow. With that said, it is still essential to examine Zillow's performance relative to other online players to ascertain its ability to dominate in the long run.

In the company's core IMT business, Zillow primarily competes with Redfin, Homesnap, and Realtor.com. Among real estate websites, Zillow is ranked as the "Best Overall" by [thebalance.com](https://www.thebalance.com) and its other brand, Trulia, is ranked for the best mobile app. Zillow also has highly positive reviews on several consumer rating websites as indicated below.

### Real Estate Website's Reviews (out of 5)

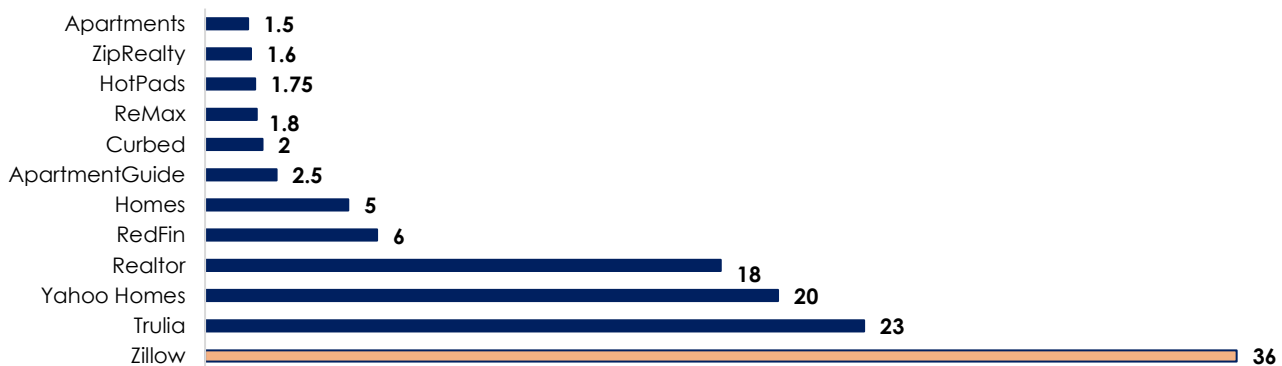


Source: G2, Consumer Affairs, App Store, Play Store

As we can see below, Zillow, including its brands, Trulia and HotPads, attracts the largest number of monthly visits. The large base of buyers and sellers on Zillow's platform

helps create a network effect. Buyers can find a large pool of property options to choose from and sellers can market to a larger population.

**US Real Estate Websites Unique Monthly Visits Comparison (millions)**



Source: [Statista, January 2020](#)

Being the most significant player in this market also provides it with a notable advantage in the iBuying business, as the data and insights about homes can be leveraged using machine learning to evaluate house prices and tap lucrative opportunities. Zestimate is Zillow's valuation model which keeps on improving with every data point accessed by the website. In iBuying, Zillow competes with Opendoor, RedfinNow, Orchard, and EasyKnock. Opendoor is the largest in the iBuying business and has expanded its operations to 39 markets across the US after entering 12 new markets in Q2. It continues to see strong potential in the market and has ramped up buying in the last two quarters. Zillow currently has operations in 25 markets and is taking initiatives to quickly expand into other geographies by raising additional debt. Please note that iBuying is a capital-intensive business as the company must first take possession of the house from the buyer upfront before repairing it and selling it for a

profit. We believe competition from Opendoor isn't a major threat for Zillow as of now as the market opportunity is large and untapped.

## **Profitable IMT segment provide cushion as Zillow invests in new segments**

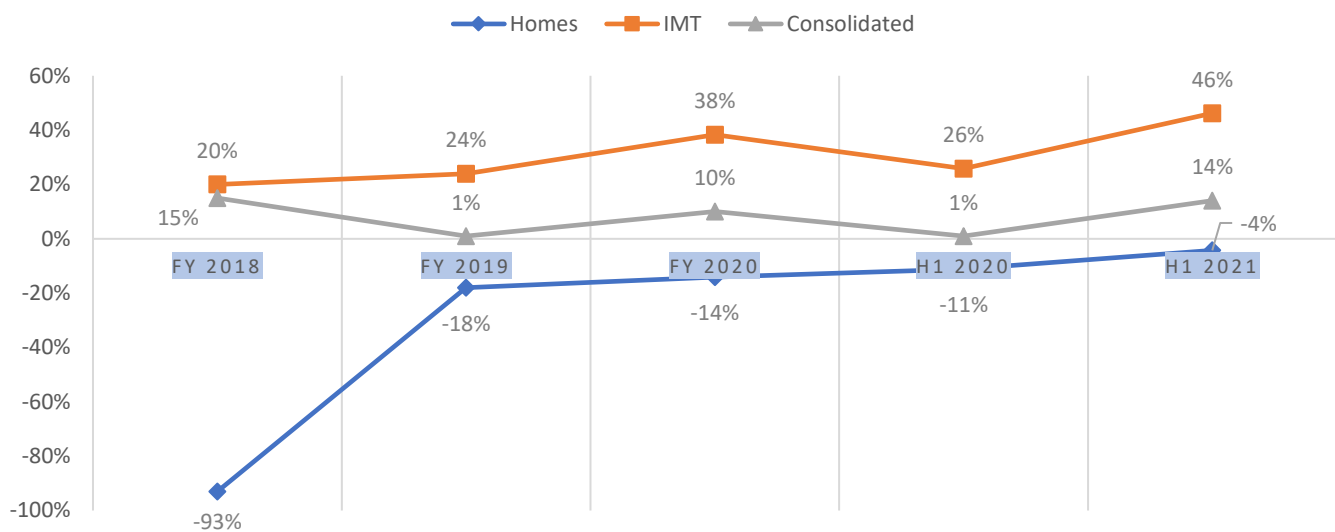
With the introduction of Zillow Offers in 2018, Zillow's revenue has grown at a robust 3-Year CAGR of 50%. In comparison, its IMT segment grew at a much slower CAGR of 14% as the business matures. However, the company has seen significant margin expansion within its IMT segment due to the scalability of the platform and improved operating efficiency. IMT EBITDA margins have expanded from 20% in FY2018 to 46% in H1 2021 but are estimated to drop to a still strong 37% in H2 2021 due to increased investments in marketing, staffing, and technology. Strong margins in the IMT segment provide the ammunition to support investments in the new Homes segment in

order to boost the top-line as well as improve existing offerings and expand the product portfolio.

As Zillow worked to expand its new iBuying business rapidly, the segment's losses initially negatively impacted overall company results. However, it has narrowed those losses

substantially in just three years, and visibility around profit margins has improved considerably as evident in the chart below. In the iBuying business, the company expects to earn 4-5% return in the long-term on homes sold before interest expense. The number is expected to be much higher after accounting for adjacent opportunities.

### Adjusted EBITDA Margins



Source: Company's filings

## Ample liquidity to support growth initiatives

The company ended Q2 2021 with a strong liquidity position of \$4.6B in cash and investments. Net debt was negative at -\$2.0B. This provides the company with the desired firepower to make strategic organic and inorganic investments as well as manage through potential cyclical downturns in the real estate industry. The company also issued \$450M of non-recourse debt in August 2021 to expand its iBuying business.

## Current valuation justified, given large market opportunity, leadership position

Zillow trades at a forward EV-to-Sales multiple of 3.5 times which is at a steep discount relative to peak multiples reached earlier this year. However, it continues to trade above its pre-pandemic valuation multiples. This is due to the boom in the real estate market coupled with improved profits visibility of Zillow Offers, margin expansion of the IMT segment, and the growing one-stop-shop appeal of Zillow. The company also trades at a high EV to Sales multiples relative to other

industry players. This is justifiable given the broad product portfolio, size advantage, and the network effect moat enjoyed by Zillow. As far as EV to EBITDA multiple is

concerned, Zillow is attractively priced because of its relatively high operating margin due to the strong IMT business.

Companies	Market Capitalization in USD Bn	EV-to-Sales (FWD; times)	Revenue 3-Year CAGR (%)	Revenue Growth (FWD; %)	EV-to-EBITDA (FWD; times)	EBITDA Margin (%)
<b>Zillow Group</b>	<b>\$24.7B</b>	<b>2.66x</b>	<b>50%</b>	<b>117%</b>	<b>49.80x</b>	<b>10.30%</b>
Redfin	\$5.4B	2.93x	42%	72%	139.90x	2.50%
eXp World Holdings	\$7.2B	1.76x	112%	47%	142.90x	1.80%
Opendoor	\$11.6B	1.21x	-	300%	-	-17.60%
Compass	\$6.4B	0.87x	-	28%	97.49x	-1.10%

Source: Seeking Alpha, Blue Harbinger Research, LLC

## Risks:

### Cyclicality of the industry:

Zillow operates in a highly cyclical industry. A downturn in the industry over a prolonged period can adversely impact the company's outlook. With that said, it is a relatively lower risk bet on real estate compared to traditional players due to its tech-oriented business model with multiple avenues for revenue generation.

### Capital intensive nature of the Zillow Offer business:

The iBuying business is, by nature, capital intensive and hence has a higher level of risk involved as compared to the company's traditional ad-based revenue model. Inability to sell in time, incorrect property valuations, or price depreciation due to market slowdowns can have a negative impact on the business. Having said that, we believe that this business needs to be looked at in terms of the additional revenue cross

selling opportunities it brings that may be higher margin and sticky. For example, 40% of the purchase originations for Zillow Home Loans in Q2 were sourced from Zillow Offers. Additionally, Zillow Closing Services also gets notable business from Zillow Offers.

## Conclusion

Zillow is an attractive bet on the ongoing digitalization and transformation of the real estate industry. The company enjoys multiple advantages such as a broad product portfolio, massive scale of operations, a large addressable market, adjacent market opportunities, vast data insight advantages, and a network effect moat due to a large customer base. At current valuations, the stock is attractively priced for long-term investors.

*We currently own shares of Zillow Group.*