CHADDD GARCIA ON CHIT CHAT MONEY PODCAST

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Speaker1: All right. Welcome in. Today we are joined by Chadd Garcia. He is the co-portfolio manager of the Ave Maria Growth Fund and the lead manager of the Ave Maria Focused Fund. Getting the introduction right there, Chadd. Why don't we start there? We're going to be talking about eDreams today, which is a European OTA (online travel agency), and we'll get into that in a second. But why don't you talk a little bit about yourself, what you do and what the strategy is with some of the mutual funds?

Chadd: Sure, sure. Well, as you said, I work for Ave Maria Mutual Funds. We have a family of six mutual funds within the Ave Maria complex. We have one mutual fund. Outside of that complex. We run close to $3 billion. I work directly on two funds. One of them is the Ave Maria Growth Fund, which is just under a billion in assets, and the newly launched Ave Maria Focused Fund, which we launched in May of 2020. That's just under $50 Million of Assets under Management. And what makes that fund a little bit different than the standard mutual fund is that it is legally a non- diversified fund. And so, I can take much more concentrated positions. The average mutual fund may have 30 to 60 holdings. The folks fund right now has around 17 holdings, of which eDreams is one of them.

Speaker1: With a I'm kind of like unfamiliar, I guess, with a mutual fund space, with a diversified one. Do they have to be like equal weight, or can you be is there a concentration limits with the typical fund?

Chadd: They don't have to be equal weight, but there are concentration limits. And so, for a standard mutual fund, you can't buy a position larger than 5% of the fund's holdings. The can position can appreciate, but the starting point can't be above 5% on the buy.

Speaker2: And you get that downside of the diversification potentially. And so hopefully you're with you. You guys are hopefully avoiding that.

Chadd: That's the plan.

Speaker1: All right. Well, today we're going to talk about eDreams, I guess kind of a basic question here. What is eDreams? Because I imagine most of our listeners haven't heard of it.

Chadd: They probably have not unless they travel frequently within Europe. But eDreams is an online travel agency or OTA, and it's focused on leisure travel primarily in Europe. So about 80% of its revenue is within Europe, and 80% of the European travel market is covered by them. They are the leader in providing flight services to travelers. So, the number one in flights in Europe, but they also other offer other services such as hotels and rental cars.

Speaker2: All right. And I guess we're getting into the details of this business. What makes it different than maybe one in the US? And I guess the first question is, in the US, flights are really not that compelling of a business for OTAs in Europe. Why is this different? Is just kind of the density of the countries and how frequent people are flying across them. Is it how many people are coming from international areas? What is it?

Chadd: Well, in the US, the top four airlines control 75% of the flight routes. If you look at Europe, the top four airlines can only control 29% of the flights. And in the in the European market, most flights are multi-layered, and most flights are international in nature and can have differing currencies or other complexities. Additionally, while in the US it's common to have 24/7 customer service phone numbers with airlines and airline apps that work well with respect to booking flights, rescheduling and adding bags or other ancillary services to your flight. In Europe, it's not it's not that common with their airlines. And so, eDreams has an app that basically gives European travelers the functionalities that American travelers have with their airlines.

Speaker2: And is eDreams the only brand under their umbrella, or do they have multiple ones that maybe if, say, a listener from Europe, they'd recognize this one, that they're actually going through your eDreams?

Chadd: So, you would be the two primary brands, but they have they have several brands.

Speaker1: Is there any historical context that's important for eDreams?

Chadd: In what sense?

Speaker1: I mean, just can you give us some of the history of eDreams and what's led it to where it is today?

Chadd: Well, eDreams was a rollup of several different travel agencies. And so, in the European markets, you may have an OTA that's strong in Germany, but maybe not so strong in France. Another ones starting in France, eDreams was put together by the merger of several businesses, ultimately became owned by two private equity firms through merging their respective online travel agencies together. And then it was taken public in 2015. Shortly after going public, the company struggled as Google changed their search engine algorithm, and that hurt the company's margins and hurt some of the company's revenue, as at the time the company was fairly dependent upon Google and other performance marketing. That led to the ousting of the CEO. The CEO of the business was elevated, and he worked on getting the company less dependent upon Google and other performance marketing.

Speaker2: Just makes sense. All right. And how did you get involved with eDreams? I guess give a little bit of historical context of when you started looking at the company and why this is kind of gets to the meat of the question of the investment thesis. Why is it attractive to you as an investment?

Chadd: Sure, sure. Well, one of the largest shareholders in eDreams is a US based hedge fund. I have a friend who invests directly in public companies and as well as private companies. One of his clients is an LP in the in the hedge fund that was a large shareholder of eDreams and so he got involved with it and invested directly through eDreams given that relationship and he was telling me about it for years. I took a deep look at it in 2019 and I saw the turnaround of the business with respect to being less dependent upon performance marketing. And I saw a business that had really failed to recover from the stumbling blocks that they had in 2015 with respect to the search engine optimization issue. And it seemed like aside from a couple of funds in the US, the company was left for dead by the European institutional investors. So, the company was trading egregiously cheap, and the turnaround was well on its way to being in place and to the point where I thought they were going to start repurchasing shares, which they did shortly after I bought them in the spring of 2019, the company started to repurchase shares right before COVID hit in February of 2020.

Speaker1: Unfortunate timing.

Chadd: Yeah. Yeah, unfortunate. Well, it was the right move to repurchase shares before then, but nobody knew that the that the world would be shut down.

Speaker1: And so, you invested at that time?

Chadd: So, we invested in our mid-cap fund in eDreams in 2019. The Ave Maria Focused Fund launched in May of 2020. The company has a variable cost model and so, my gut told me that they would make it through COVID. But you really saw that work out when they reported their Q1 quarter, which was in June of 2020 because that quarter was fully impacted by COVID, and they had a very de minimis cash burn. And so, I was comfortable that they probably had a two-year runway. At that point, if traveled in, it improved and at that time. Travel was down 66%. So, I was comfortable that they were going to make it through the COVID period. And they did so without having to raise equity or additional debt, which was fairly unique in the in the online travel agency sector. I mean, maybe Booking didn't have to raise equity, but I remember Expedia raised some from Apollo and their European competitors were raising money, too. And so, I thought that they would exit covered in a position of financial strength and do well and when I figured out that they were going to make it through, I started buying it in the summer of 2020 and the new I've been very focused on. So, at that point we held it in two funds in the complex, the big cap fund and Focused fund.

Speaker1: How long I guess, did the was COVID like really impacting eDreams' business? Had it kind of passed after a year or so, or is the recovery still going on? And then we saw Visa with saying that their cross-border travel is up like 49% I guess in the recent quarter. So, it seems like that recovery in Europe is still ongoing and it's been a bit slower in the US. Is that how it is? There's still kind of progress to make to get out of the COVID headwind?

Chadd: Well, keep in mind that Visa is tied to total travel. In business, travel is going to lag. Leisure travel dreams is 100% focused on leisure travel. And so theoretically, that should have bounced back quicker because particularly Europeans love to travel. I mean, things are going to have to get really bad for them to not travel on their on their vacations. Right? But COVID had two impacts on the business. The first one was you had economies that were shut down. And so that's going to impact your bookings. That started to change in the summer of 2021. So, June may have been 2% positive on the number of bookings versus pre-COVID levels. And then it went into the mid-teens in July and then it went up to 30% growth over pre-COVID levels in August of ‘21 and with a brief pullback in December and January of ‘21 and January of ‘22 because of the chronic variance. The bookings for eDreams versus pre-COVID levels has ranged between 30 and 58% higher than pre-COVID levels for each of the months. So, Europeans are traveling and they're traveling pretty hard. At the last measurement that we had was as of August 28 when the company reported. And so, through August of 28, the bookings are quite high. And that, by the way, includes the invasion of Ukraine, which dropped bookings a little bit, but it didn't go negative. It was still strongly positive.

Speaker1: All right. So, I think I've got.

Chadd: One more thing to mention on that. The other way that COVID affected it was that when people started to travel coming out of COVID, they took flights were lower in duration and a closer distance to home in case some regulatory rule changed, and they didn't want to get stuck halfway around the continent. They wanted to be closer to home so maybe they could drive back if they had to. So that that was one of the other changes. But I think that that is normalizing at this point.

Speaker1: That makes sense. And I guess one big transition that's there, they're sort of in the middle of right now is the prime program. Can you explain what the prime program is and what its financial impacts could be on the business?

Chadd: Yeah, well, the Prime program is really an extension of the work that Dina Dunn, the CO, has completed on getting on sites like Google and other performance marketing. So, the first I was to get into Prime, I would first start with the development of their app. So right now, 50 to 60% of the bookings are made via the app. And so, if a booking is made via the app, that means that that booking is not does not originate with Google or some other metasearch provider, that leaves that leaves 40 to 50% of the remaining bookings to be done on a desktop computer, which may be done directly or may be done through performance marketing. And so, the first big step the company did to get away from Google was to develop the app to get people accustomed to using it. So, they book directly with that. The Prime program is the next evolution, and with the Prime program, it's modeled after Amazon Prime or even Costco's program. It's called Prime Funny, funny enough. And in that program, a customer pays eDreams €25 a year, and for that they get discounts on travel bookings. It usually pays back within two bookings. And what I think the company is doing is basically giving away all of the booking margin that they're going to that they make on a customer on each transaction. Give that back in the form of discounts to the customer. So, for the customer, it's a nice low-cost value proposition. And the margin that eDreams is going to make going forward is just the value of the Prime subscription.

Speaker2: It seems like the big thesis here is that the Prime subscription changes the unit economics for the business. Can you maybe go in and we probably should have hit this earlier, but can you go into more detail on kind of the major costs that eDreams might have? I know people worry about the Google tax and anything else, but you mentioned this is a high variable cost business. Just what are the major costs here and kind of what margins do they have and maybe what could they have in the future if the Prime program continues to see success?

Chadd: Well, you want to look at net revenue, so the revenue isn't the price of the ticket. The revenue is the booking fee that they that they make when they when they sell a ticket. Right. And that historically was between 40 and €55 per booking. And with that they had to cover their fixed costs. So, let's say they're 15%, 20% EBIT margin business. The prime customer the prime program should get them to. I estimate 32% EBIT margins. And the only thing that they're making in that would be the prime fee. Any margin that they make from the booking, they return to the customer in the form of a of a discount.

Speaker2: And that the positives there is that it's just more reliable revenue because it's subscription and it's going to be higher margin. Now I guess the big question is what's the future like for eDreams? How many subscribers can they get with this Prime program? Is there anything else that's important besides the Prime program? And I guess do you have any I know investors and listeners can look them up on the website, but any context to how many subscribers? I think they have like 3 million, unless I'm remembering that incorrectly?

Chadd: Yeah, three and a half as of the end of August. And so, to give you some context, they ended, or they began June 1st of 2021 with 1 million subscribers. In the next year, they gained an additional 2 million net subscribers for 3 million as of June 1st of 2022. As of the end of August, they had three and one half. When they report in a couple of weeks on November 15th. Maybe they'll have three and three quarter million as of the end of the quarter, or maybe 4 million as of mid-November. I don't know. We'll see. I'm anxiously awaiting that now. What I believe is happening is that they are likely using Google and performance marketing to attract customers and, in an effort, to convert them into Prime subscribers. And so, while they picked up 2 million net new subs last year. Their financials haven't reflected it yet because they incurred acquisition costs to get to them. That being the performance marketing now. Once they acquire a Prime customer. When those customers rebook with eDreams, 75% of the time they come directly either through the app or direct to their website. And so, there's very low re acquisition costs of that customer for future bookings. And so, while the financials have yet to reflect the transition to the Prime business. They should start inflecting either this quarter or the next quarter as the Prime subscribers that they gained last year, which were mostly in the second half of the year, have their first anniversaries.

Speaker2: Well, it's fascinating. What? Are there any competitors here in the OTT space? Because especially in Europe, I know maybe Booking has a big presence and not really. I can't remember exactly which brand. I guess what I'm trying to get at is what is stopping them from getting 10 million subscribers on the Prime program and, you know, kind of dominating the European continent?

Chadd: Well, on flights you have experience that's big and flights and eDreams is twice as large as their as the next largest competitor and flights. They're three times as large as a as the third largest competitor so they're the leader in flights and. 80% of the time the first dollar spent in travel is spent in flights. And so, what do they know? 80% of the time, they know who you are. Where are you from? Where you're traveling, when you're traveling, how much you paid for your ticket. And so, I think that gives them a nice advantage. Furthermore, they can sell you hotels now, so they'll sell your flights. And hotel Bookings is big in hotels, but Bookings has agreements with their suppliers that they can't charge lower than what their suppliers are charging. So, like, if you're if you're going to go to London and you find a Marriott, well, you can book Marriott at the same price. You can book direct as you could on Bookings. The interesting thing about having flights and in a hotel is that you don't know where the savings are coming from. And so, eDreams can essentially out price Bookings. What's Booking going to do about it? Probably nothing except for cede some market share, because if they get into a price war with them, they're going to they're going to crash their margins on the business that they keep, as opposed to ceding a little bit of market share to eDreams.

Chadd: I mean, it reminds me a lot of HEICO. I don't know if you know the parts business, but in that business, G.E. makes a part for four, for four for an airplane. The FAA has to approve all the parts that go into the plane, which essentially gives a monopoly until Heiko comes along and replicates the part and gets the part approved. HEICO charges 30% discount and captures 30% of the market. Geez, I can get into a war with them because why kill the margin on your 70%? I think there's a similar there's a similar competitive dynamic going on here. And so that raises the question, while Bookings is a big company with a lot of resources, why don't they get into flights and dynamic packages like eDreams is doing? Well, their business is really more of a metasearch driven business, and so doing so would require changing how? They do their business globally, not just in Europe.

Speaker1: Can you give us a sense, I guess, that the valuation for your eDreams, what do you think? What are they valued at today? And then I guess, what do you think the future holds in terms of earnings potential?

Chadd: So, the company's stated goals is a $180 Million in EBITDA by fiscal year 25, which is March of 2024, so a year and a half out. But they haven't really said as loudly as that they still expect to grow in fiscal year ‘26 and the EBITDA of 180 million contains a massive amount of growth expenses that's running through the income statement as opposed to the balance sheet as a traditional manufacturing business would be. If GM builds a plant, that plan is amortized and depreciated. The customer acquisition costs for eDreams to grow the Prime program is running right through the income statement. So, I suspect that the evidence is probably closer to €260 million. If they achieve their fiscal year ‘25 revenue goals and they're still growing that business as opposed to the 180. And so right now you've got an €800 million business that it'd be generating EBITDA between 180 and 260 and a year and a half. I mean, what's that worth to you?

Speaker2: I'm assuming it's pretty strong conversion to cash flow?

Chadd: Yeah, I mean, there's hardly any Capex in the business and it's just tax and they got a little bit of debt. So. Gotcha. Very, very high conversion. I think that I think the business is worth 20 to €30 today. And I'm not I'm not alone in that. There's a handful of very sophisticated investors in the stock, I think. I think their numbers are kind of around the same area. I think if you put a gun to management's head, they'll probably tell you the same thing.

Speaker2: Gotcha. And for listeners, the stock price is around $4 to $4.20, low fours today. So, the stock results haven't looked too great this year. Why do you think that is?

Chadd: If you go back to the 2015 when the company IPO and then it had its issues with Google, I think a lot of the European institutional shareholders got burned on the IPO and then the stock went below €5. And institutionally, it may have been a problem for a lot of the institutions in Europe to hold the company once it went below €5. Coincidentally, in 2018, the company did receive an unsolicited bid from a competitor. And this is while the turnaround was working, and the board unanimously rejected the offer. It's not public what it was, but I'm thinking it's north of €7 a share, which is materially higher than where the company is at today. But the company continued to work on the turnaround, and they got to a position, as we discussed, where they can buy back some shares. The shares briefly got above five €5, €6 pre-COVID. So, the turnaround was starting to work, and it was starting to be recognized by the market. And then COVID hit. It went down below €2 per share. It got up to north of €10 at the end of last year, and then they raised a little bit of money, a little bit of equity, which some investors were upset that they did that. But the timing wise turned out to be great because it allowed them to refinance the debt in the business.

Chadd: And do it at a pretty advantageous interest rate given what's happened subsequently. But that started them on a downtrend. And then within a couple of weeks, you had the invasion in Ukraine, which didn't help the sentiment. And so, the way I look at it is that. You've got three different classes of investors in the stock right now. You've got 40% of it is owned by the two private equity firms that took a public. There's a handful of savvy investors that have peeled the onion back and understand the Prime program and understand the economics and understand that the financials will start to reflect those economics shortly due to the anniversary and of all the Prime program members that they've gained in the last year. And these shareholders know the value of the company and they're not going to sell it at today's price. And so that's taken out of the market. And so, that leaves you with probably a European retail and a handful of European institutions who are looking at the financials on their Bloomberg terminal and not feeling the onion back and then seeing the sentiment from the inflation and news in Europe and the war in Ukraine and probably the marginal shareholder in the company is just very negative on the sentiment. And that's not going to turn until the financials start to reflect the turnaround of the business.

Speaker2: Yeah, makes sense. Alright, let's hit management. Before we hit our wrap up question, what are your thoughts on them? I know you mentioned that you kind of liked how they took advantage of the higher stock price to issue some equity, but do you think that well, you're not like an actress or anything, but do you see them buying back stock, I guess, going forward? And how are they going to balance that between the debt load, which I think according to Clifton, you can correct me if this is the wrong number. It's about €400 million in debt. It seems like if they get to that EBIT number, it should be fine to pay that down. But how much room do you think management will have to buy back some shares?

Chadd: Right. Well, I think I think management is strong. And one of my risks that I identified or wrote down in my investment committee, remember years ago was that one of the competitors could acquire eDreams in an effort to get to the CEO or try to poach a CEO and hire the CEO away from eDreams. If you look at the last CEO that was let, go from Expedia because he didn't solve the Google issue. Right. And what has Dana done? It seems like he's solved the Google problem. And so, I'm really high on management. They are quite thoughtful, the very long term focused on the business, which is nice to see as an investor. I would see them paying some debt down before doing a share repurchase just because of the covenants that they have that they're that they have on their debt. I think that the market would probably view a debt paydown in the same way that it views a share repurchase.

Speaker1: So why do you think, I guess going back to the equity raise, why do you think investors were upset about the equity raise that they were able to pay down the debt?

Chadd: I don't think that either the company is going to generate cash and I don't think the equity raise was needed. I think the equity raised was pushed on them by the banks that are in the deb. To be skeptical, I would say that the banks did it to get fees and now that's shocking. But, you know, that being said. I do think that the banks probably came out wanting a much larger equity raise and management pushed back pretty hard. And in the end, it worked out because the interest rates had shut up and they got a nice rate and were able to get a deal done. Now it would be much harder to do it.

Speaker2: Gotcha. One more competitive risk I wanted to hit because I know maybe any listeners in the US might be thinking of this, but it might not matter. Is Airbnb. I know they have a pretty strong presence in Europe, but they might not overlap with eDreams business. Are they competitive threat or do you see that as kind of two separate parts of the travel market?

Chadd: I would look at LinkedIn and looked at the people who used to work at Airbnb in their flights program that was scrapped during COVID. Airbnb wanted to get into flights. So, I would just say that if they really want to start that program up, there's an easy way to do it.

Speaker2: Buy eDreams for $10 a share.

Chadd: $10 a share.

Speaker2: Maybe $20? Yeah. All right. Well, that's an interesting I didn't think of that one. Airbnb. That actually makes a lot of sense.

Speaker1: Okay. All right. Last question on eDreams. And we try to ask this with all our deep dives pre mortem, how could the investment in eDreams go poorly? What could kind of go wrong here?

Chadd: Yeah, I think they're fairly insulated from a competitive position. I think that if it could go wrong, as I've said earlier, you have. A handful of firms that own this company and know the value of it. Some of them are in Europe, some of them are in Asia. A lot of them are in the US. These firms own eDreams in very high concentrated positions. If one of them had an issue at their fund, maybe with another holding that blew up and were redeemed, then that could put a lot of selling pressure on a company that's already has low liquidity. That said, there are several savvy investors in the stock, and I imagine if somebody is blowing up, then the rest of investors would step up and buy the position out.

Speaker1: Okay, I have one more question. We didn't write this one down, but you've been investing for a while, I take it. And we have a pretty young listener base. So just sort of a general advice question. What kind of words of wisdom or piece of advice do you have for any young investors today?

Chadd: Well, read constantly and don't be afraid to ask for help, particularly about from people that are already in the business. It's been my experience that people like to help people out, particularly if that person's not going to be a threat to them. Young people are not going to be a threat to an established investor. Feel free to reach out to them and be persistent.

Speaker1: Okay, Perfect. Well, for any listeners that want to, I guess, keep up with you or keep up with any of the holdings, what are the best places, I guess, to do that?

Chadd: Yeah, avemariafund.com com is our website. You can learn a lot about us there. They can give us a call at 866-AVE-MARIA.

Speaker2: All right. We'll make sure to put the link to the website in the show notes and check out all your guys' information.

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