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TREE - Q3 2010 Tree.com, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Tree.com Third Quarter 2010 Earnings Conference Call. Today's call is being recorded. At this time I would like to turn the call over to Doug Lebda, Chairman and CEO. Please go ahead.

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Thanks, operator, and thank you to everyone for joining us today for Tree.com's Q3, 2010 earnings conference call. First, a quick disclaimer; during this call we may discuss Tree.com's plans, expectations, outlook or forecast for future performance. These forward-looking statements typically are preceded by words such as we expect, we believe, we anticipate, we are looking to or other similar statements. These forward-looking statements are subject to risks and uncertainties and Tree.com's actual results could differ materially from the views expressed today.

Some of the risks we face have been set forth in our earnings release and in greater detail in our periodic reports filed with the SEC. We'll also discuss certain non-GAAP measures, such as EBITDA and adjusted EBITDA. I refer you to today's Press Release for all the comparable GAAP measures, definitions and full reconciliations of adjusted EBITDA and EBITDA to net income.

As we do on each call, I'll first address the overall results for the quarter and then turn it over to Tamara for a more detailed financial review.

Overall we had a good quarter. We posted adjusted EBITDA of $5.5 million, which was an improvement of 62% or $2.1 million over Q2. This improvement was made possible in large part by a 16% increase in revenue over last quarter. As we mentioned in the last call, we'd been anticipating an increase in interest rates in the latter part of 2010, which would have logically put pressure on the lending business. Instead rates dropped to yet another new historical low in Q2 and thereby created another surge of refinance activity.

This mini refi boom is something we've experienced before but did not anticipate continuing over the long term. Interest rates are likely to creep back up, which would put pressure on our lending business as you would guess.

Now let me provide a few highlights from our individual lines of business. At Lending Tree Loans we continued the strong bottom line performance we've seen since early 2009, delivering $12.5 million in adjusted EBITDA in the quarter, a 73% increase over Q2. This segment of our business continues to benefit from the low rate environment. The decline in rates during Q3, which started near the end of Q2, provided the fuel for a 25% increase in funded refinance loans and 29% increase in total revenue.

Looking more broadly at LTL, our leadership team there has done a great job of improving efficiency through process and technology and with that in place we are positioned to now focus on scaling the business and further leveraging the platform, which we think will drive incremental profitability. We intend to start by expanding our team of licensed loan offers organically through hiring and at the same time we've also been exploring potential tuck-in acquisitions.

Turning to our lending exchange, this segment also benefitted from the drop in interest rates and the corresponding increase in refinance activity as seen by a 40% increase in transmitted refinance leads quarter-over-quarter. This increase in lead volume proved to be an important proof point in the effectiveness of our new pricing flexibility.

Naturally the excess volume available to our network lenders put downward pressure on prices, but our flexible market-based pricing allowed lender demand for our leads to remain high and with the lower prices and the high quality that our Lending Tree leads are known for, we were able to take market share away from our competitors and realize a 5% improvement in the expected value of our leads.

On the marketing front, our key initiative in Q3 was the launch of several new direct response adds designed for new product offerings including our "look before you lock" tool and a $1,000 best deal guarantee. Moving forward we plan to continue this direct response approach as one of our most effective ways of driving consumer store sites.

In our non-mortgage verticals, we continue to invest marketing dollars as we position this businesses to grow and as a result they're continuing to gain traction. Combined the Tree.com businesses, which include education, insurance, home services and auto, generated over 186,000 transmitted consumer requests in the quarter, which represents over 58% of the total transmitted exchange leads, our third consecutive quarter of growth. In addition, I'm glad to announce that the new Tree.com website was launched this quarter in beta and we're continuing to add important features and content throughout Q4.

In the real estate segment, not surprisingly, this business continues to operate in a difficult market. After a seasonal up tick in the last quarter, Q3 revenue was down 32% from Q2 on 31% fewer closed transactions. While no less disappointing, the difficulties here have been felt across the industry as the latest data issued by the National Association of Realtors indicates existing home sales in Q3 were down 25% below Q2 levels.

That said, we've been reviewing potential strategies to improve performance in this segment and are very pleased to have announced today that Steve Ozonian is joining the Company as CEO of the Real Estate business. Steve has been a member of Tree's Board of Directors since 2008 and is a recognized expert in the real estate industry. During his career he's had several executive positions in the real estate industry including Chairman and CEO of Prudential's Real Estate and related businesses and CEO of Realitor.com. He's been a tremendous asset to us as a Board member and I'm very excited that he will be taking an active role in the management of this business.

Steve's first initiative will be to take other real estate business in a new direction expanding beyond our core Company-owned brokerage business with the creation of a trademark license company or TLC model. The TLC strategy is one that would allow brokers across the country to affiliate with and take advantage of the Realestate.com brand similar in some respects to a franchise but with the advantage of a lower cost structure and greater flexibility than a traditional franchise model.

This new strategy, which we've been working on for the last few months, will leverage the unique customer acquisition capabilities of Real Estate.com along with the value of a great brand and new leadership. We will also be forging a stronger relationship between our real estate agents and our mortgage operations at LTL, which will become more important in a rising rate environment where refinancing activities slows and purchase mortgage takes a more prominent role.

Under Steve's leadership, we plan to create a Company focused on providing a superior value proposition for our customers with integrated services like mortgage, title and insurance and we'll provide a compelling platform to attract both independent real estate brokers and those with existing franchise agreements. With this new strategy will come some modest investment in 2011 but we believe long term that this model will produce substantially higher returns for our shareholders.

And with that, let me turn it over to Tamara to take you through the detailed financial results.

Tamara Kotronis - *Tree.com, Inc. - SVP, Financial Planning & Analysis & IR*

Thanks, Doug, and good morning to all on the line today. As you see in our release, we reported $5.5 million of positive adjusted of EBITDA, $2.1 million better than the prior quarter on revenue that was 16% above Q2.

On a GAAP basis our net income was $1.8 million or $0.16 per share, which was an improvement over the prior quarter net loss of $800,000 or $0.07 a share.

Before I get into the segment results, I'd like to highlight that during the quarter the Company changed its accounting policy for inter-segment revenue and inter-segment market expense between Lending Tree Loans and the exchanges segments. This change only impacts the segment results and does not impact the consolidated financial results of Tree.com.

Regarding the policy change, previously we accounted for the cost of LTL's inter-segment purchase of leads from the exchanges through the recognition of inter-segment revenue for the exchanges in inter-segment marketing expense for LTL. Each of these items was eliminated in the consolidation of total Company results.

We are now using a cost-sharing approach for these marketing expenses whereby Lending Tree Loans and the exchanges share the expense based on the average cost of leads generated and the quantity of leads received by each segment. There is no longer inter-segment revenue or inter-segment marketing expense related to these leads. We believe that this cost sharing approach more closely aligns the overall goals of the Company with the goals of each segment's management and will ultimately drive the Company to better performance.

Segment information for prior periods contained in today's release and in the following comments reflects this policy change.

Now getting into this segment's Q3 results, as Doug mentioned earlier, Lending Tree Loans adjusted EBITDA was $12.5 million in the quarter, which is $5.3 million greater than Q2. Revenue improved $8.2 million or 30% over the prior quarter.

The drop in interest rate had a clear and substantial impact on the quarter's results. At LTL refinance loan requests transmitted from Lending Tree increased 45% over Q2. Including purchase mortgage requests, total consumers transmitted from the exchange increased 33% over the prior quarter. As such, closed loans transactions increased 17% and revenue from origination and sale of loans was up 33% over the prior quarter.

In addition, we realized a 12% increase in margin over Q2 in this record-low interest rate environment. However, the provision for loan losses increased 22% from Q2 to $3.7 million as our loss frequency and severity for loans sold in 2008 was higher than forecasted in our models.

For our recent filings, Lending Tree Loans renewed its warehouse line agreement with JP Morgan Chase running through October 29th, 2011. The renewal includes an increase in borrowing capacity on this credit line from $75 million to $100 million. Effective with this renewal our committed borrowing capacity has increased from $125 million to $150 million with an additional $25 million uncommitted.

Now, moving on to the exchanges, revenue was up $900,000 or 6% over Q2. Total matched consumer requests, which includes both mortgage and non-mortgage, were up 17% quarter-over-quarter. This increase in transmitted consumers was driven in part by the surge of refinance activity fueled by low interest rates. As such, we experienced a 40% increase in refinance loan requested matched to lenders but purchase mortgage requests dropped 20% so in total loan transmits were up 5% quarter-over-quarter and LTL is continuing to take a greater share of the total volume generated by the brand.

The remainder of the growth in total matches was driven by our non-mortgage verticals, particularly insurance and home services. In total, our non-mortgage verticals saw a 28% increase in total transmitted services requests quarter-over-quarter and these verticals combined now make up nearly 23% of total exchanges revenue, virtually flat to Q2.

Adjusted EBITDA for the exchanges was a loss of $1.2 million, which is down $1.6 million from Q2. The deterioration in adjusted EBITDA quarter-over-quarter was driven by increased marketing. The increase in marketing was due in part to television commercial production for spots that aired in the quarter as well as an increased variable spend for the non-mortgage verticals. Non-mortgage spend was up 60% as we tested new tactics and completed another book drop for home services.

Moving on to the real estate segment, the difficult market influences, such as low home prices and sluggish sales activity, continue. After an up tick in closings and revenue in the last quarter, Q3 saw a 32% drop in revenue compared to Q2. This was driven by a 31% decrease in the number of closed real estate transactions. As Doug stated earlier, while this is not a welcome development, it is something that's enveloped throughout the industry with fewer closings nationwide.

The stabilization of average home prices that we highlighted last quarter did continue into Q3 with the average value of closings staying virtually level to the prior quarter at just under $200,000. Agent count at the end of Q3 was just 2% lower than the end of Q2 ending a dramatic slide through the last few quarters.

Lastly, our corporate segment, operating expenses increased $1.1 million quarter-over-quarter and decreased $2.7 million year-over-year. The quarter-over-quarter increase was largely due to higher incentive compensation expense and higher professional fees. The year-over-year decreases in operating expenses were primarily driven by lower professional fees and employee costs reflecting prior cost cutting initiatives.

As for guidance for Q4, we expect normal seasonal downturns to affect our results. However, while we continue to expect that increasing interest rates will put pressure on the lending business, we're nearly a month into the quarter and rates remain low. As a result, we would expect Q4 adjusted EBITDA to be between breakeven and $2 million.

Now, briefly turning to the balance sheet, we ended the quarter with approximately $68 million in cash including $11 million of restricted cash, down $5 million from the end of Q2. The change from last quarter principally reflects share repurchases, timing of loan portfolio fundings and sales and outflow payments on loan loss settlement discussions we had in Q4 '09. We have about $1.4 million remaining to pay on those loan settlement matters.

We ended the quarter with 11.2 million common shares outstanding with another 1 million options and 593,000 RSUs outstanding. During the quarter under the previously announced $10 million share repurchase program we began in February the Company repurchased 182,667 shares at an average price of $6.69 in open market transactions.

Through September 30th, 2010 the Company has repurchased a total of 670,025 shares at an average price of $6.99 and has approximately 5.3 million of repurchase authorization.

And, with that, I'd like to hand it back over to the operator for Q and A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And we'll go first to George Askew with Stifel Nicolaus.

George Askew - *Stifel Nicolaus - Analyst*

Congratulations on a very strong quarter. Let's see. I actually have several questions. You're on a pace to do about $2.6 billion in mortgage originations this year. As you hire the new LOs and you've boosted your warehouse lines of credit, what -- how will your mortgage origination pace change?

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

It will basically increase directly in proportion with loan officers, assuming we can generate the lead flow to keep them fed. The good news about the Company and where we are with LTL is basically the overhead costs have been restructured. The technology has -- we've put in great technology including a new loan origination system and so on and new front end technology with the phone systems and lead management systems, so basically the thing scales very nicely and now it's really just a matter of adding people and leads. So it will basically go directly in proportion with people.

George Askew - *Stifel Nicolaus - Analyst*

And if you add 40 new LOs what percent increase is that?

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

It will be roughly 25%, sorry 20%. We have about just under 200 people for that.

George Askew - *Stifel Nicolaus - Analyst*

Got you. Okay good. On the exchanges, Tamara, I think you mentioned -- I thought you mentioned the revenue generated by the non-mortgage leads, what was that number?

Tamara Kotronis - *Tree.com, Inc. - SVP, Financial Planning & Analysis & IR*

In the quarter our new verticals contributed 23% of the total exchanges revenue.

George Askew - *Stifel Nicolaus - Analyst*

How, Doug and Tamara, can you guys give us a little sense of how you're monetizing those leads? I mean, are you seeing some fall on the floor? Are you able to sell everything? Are you -- is there a little bit of a variable pricing strategy, whatever you can tell us?

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Sure and we're not going to give out a ton of information, not because we don't have it, just because for competitive reasons I don't want to get into vertical by vertical because in each of these verticals there is competitors and there's lots of data in terms of the cost of getting a lead and the revenue that you get from them and that varies by vertical. We don't want to give that out but in general here's how it works.

First off, I would say the good news right now in the emerging verticals is that what we call cap in the system, which is the demand for leads, demand for leads is far outstripping right now than supply of leads pretty much across the verticals. That not only pushes up pricing but also opens the door to marketing, so if there's any -- so the thing that we're working on right now and we're either working on supply or demand, the thing we're working on right now is getting leads through marketing, whether it's Facebook advertising where we're doing a lot more EDU advertising or just on line acquisition. When there's more demand for leads than we have, we step on the marketing gas and that's what our focus is.

The good, the reason we've got a lot of demand for leads right now tactically we've centralized all of our sales under Mark Fowler's very able leadership. He came in from LowerMyBills/Experian, has done a wonderful job organizing all of our vertical sales teams, but also because we have a high quality lead reputation, a high quality lead strategy and that's doing very, very well in this market across the verticals.

There's every supplier or every buyer of leads had dealt with suppliers who say, "Gee these are low quality." It's affiliate traffic, etcetera, etcetera and that's just not our strategy so we generally position ourselves at a higher price and a higher quality and that's where we see the industry moving.

George Askew - *Stifel Nicolaus - Analyst*

Good and just the last question, how does the new realestate.com strategy differ from a more traditional franchise agreement? I'm not sure I caught that.

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

It's in many ways it is similar. I think the difference is first off I would just say that one difference is the we will charge a lower price for the core sort of "franchise services" and that's just simply because brokers we find are very unhappy with their franchises in general. They're paying a lot of revenue. One broker I talked to said my franchise fee is essentially all the profit that I would be making right now and the guy is roughly breakeven and that's essentially his profit margin he sees as going to somebody else and they're not really providing the services.

So what we plan to do is charge a lower franchise fee, if you will, although it won't have a lot of the legal restrictions of a franchise, and then we will make money through other services and particular lead generation services but also through mortgage, title and home insurance. So we'll have more of a pay-for-service model but with a lower franchise fee. And the reason you do this is basically if we can through companies that we license our trademark to and through these other services if we can get a national footprint we can then advertise nationally, which is much, much more efficient and is more in our sweet spot of what we do than the advertising we do today, which is much more locally based.

In addition, the big push will be now that we've gotten Lending Tree loans not only stabilized but very good in the purchase business, we plan to tie together mortgage and real estate much more aggressively. We essentially have 0% mortgage capture right now of our real estate leads. Best in the industry would be over 50% and we hope to trim this towards 50% so we think we can provide much more value to traditional real estate brokers.

We'll have the flexibility that they can brand themselves realestate.com if they would like to but they can also keep their own brand if it's strong in the market and use realestate.com as a sub brand by leads, use technology, use mortgage. We think that for a real estate -- we've seen with our own realtors that being part of Lending Tree is a real -- is a great benefit for them because it's a brand that they can know and trust and we think that will play very well with brokers if they can say, "And by the way all of our loans are brought to you by Lending Tree and it's great service with low price guarantee," etcetera, etcetera so we think it's a good strategy and it's not a lot of capital invested, although we will have to invest some as we build this out, but we think it's the right path forward for the real estate industry to try to get growth.

By the way, the only other thing I would say about real estate is some people would say, "Hey hunker down in this environment." I mean quite frankly we take the opposite approach. The real estate environment cannot get any worse. It will only get better. It might take some time to get better and so we think now is the time for this type of strategy.

George Askew - *Stifel Nicolaus - Analyst*

That's terrific. Thank you very much.

Operator

Mark Mahaney, Citigroup.

Neil Doshi - *Citigroup - Analyst*

This actually Neil Doshi stepping in for Mark. Question on the exchanges, as you kind of grow the non-endemic, the emerging verticals, do you see growth really coming from sticking with the existing verticals and just going deeper into that or possibly expanding into new verticals like by credit cards and service providers etcetera for home improvements? That's my first question.

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Sure. It's actually going to come both ways with we will be in every vertical where there is a vertical on line and lead generation, where consumers want to comparison shop and get ratings and reviews and where advertisers want to buy leads instead of impressions we will have a play in it. And whether small or big and the reason is we actually believe, particularly as we build the Tree.com brand, which will be all about helping you make smart decisions, we believe that we can bring you in through any vertical and then introduce you to the other verticals over time.

So we will both grow into -- and each of these verticals by the way, they're managed somewhat separately, although the marketing and technology is all built on the same platform. So we hire fantastic managers, tell them to grow their own individual vertical but at the same time manage the marketing on a centralized platform so we can keep a handle on the ROIs so I hope that every manager we bring in gets deeper and grows his or her business independently but at the same time we will add verticals and we will be in every vertical on line where this type of service makes sense. Anywhere that somebody says I'm the Lending Tree of "insert your category" we will be there.

On services in particular that you raised we think is a great opportunity and we will not only add other types of service providers to our home services business not only off line but on line. Right now we're using the Done Right brand. That will be integrated into Tree.com as well. We have a great sales team based in Denver. Of buyers of leads we hear that people want an alternative to the two big players out there in [NG's] list and ServiceMagic. So we will be that third alternative.

And on the consumer side we think that we can build a great value prop for the customer too so we absolutely will add as well.

Neil Doshi - *Citigroup - Analyst*

And also, Doug, you mentioned doing some tuck in acquisitions. Is that primarily to expand your loan officers or would that be to get new functionality and tools to enhance the [needs] or experiences site?

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

It would really be in -- we're always open to acquisitions and we make -- we've made several. In when I mentioned it in the call specifically in the mortgage business and it's something that we explore, it would really be to find mortgage companies that can I would say do two things; one, add to licensed loan officers and two, have a capability in servicing types of leads that Lending Tree Loans doesn't do today, in particular the short form leads. That would be kind of what we're looking for.

It's not a mandate that we will do it but we always keep our ear to the ground and we're open to it and the reason is we've gotten much more comfortable in the mortgage business that, particularly with short form, short short form, 800 number leads, cross sells from real estate, purchase mortgage, I am highly confident that we can drive in increasing lead flow to that business in these alternative lead types and so I know we can feed a much larger business than we have today so we're going to hire aggressively. We've already been doing that.

We're going to grow in Irvine. We're going to keep growing in Charlotte and we're open to acquisition but it's basically a build versus buy now with this. And it's got to be the right company too so no requirement that we do it but we're certainly exploring it.

Neil Doshi - *Citigroup - Analyst*

And lastly, Tamara, could you just walk us through your cash balance less your commitments and contingencies?

Tamara Kotronis - *Tree.com, Inc. - SVP, Financial Planning & Analysis & IR*

So we ended the quarter with approximately $68 million in cash and that included $11 million of restricted cash, which was down $5 million from the end of Q2. Now that change from the last quarter was principally due to the share repurchases in the quarter, the timing of loan portfolio fundings and sales and the outflow of payments on loan settlement discussions that we had at the end of '09. And we currently have about $1.4 million remaining to pay on those loan settlement matters.

Neil Doshi - *Citigroup - Analyst*

And do any of the banks still require you to keep a portion of your cash as collateral?

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Yes we still have a tangible new worth requirement that went from [$40.4 million] down to $25 million.

Neil Doshi - *Citigroup - Analyst*

Great thanks again, guys.

Operator

(Operator Instructions). [Ed Entilian], Chartwell Investment. Please check your mute function. (Operator Instructions).

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Operator, are there any other questions?

Operator

It appears there are no further questions at this time.

Doug Lebda - *Tree.com, Inc. - Chairman & CEO*

Fantastic. Well, thank you all for your attention and we'll certainly look forward to seeing you and talking with you again next quarter and if there's anything we can do in the meantime, feel free to reach out, as always.

Operator

That concludes today's presentation. Thank you for your participation.
