HORAN CAPITAL MANAGEMENT

PORTFOLIO ACTIVITY – Q1 2022

By Louis S. Foxwell, CFA and Matt Holman, CFA, Senior Equity Research Analysts

Buys

We initiated a new position in **Etsy (ETSY)** late last quarter and continued building the position in Q1 as the price came down further below our fair value estimate. Etsy is a two-sided marketplace connecting buyers and sellers of vintage, antique, custom, and personalized merchandise. Focusing on this "special retail" category means that Etsy does not aim to capture the everyday shopper like Amazon or Walmart but focuses on shoppers looking for unique items for special occasions. The marketplace aggregates sellers of differentiated items, whereas bigger marketplaces focus on commoditized items sold at a mass scale.

The company makes money by charging fees on the transaction volume in its marketplace. It also earns revenue for performance marketing and promoted listings as well as fees for using its internal payment processing services. The aggregation model takes care of demand generation, marketing, website design, payment processing, and logistics. This allows sellers to focus on what they do best, producing unique merchandise and monetizing their individualism. Insourcing these tasks also adds to the value proposition and allows Etsy to command a higher cut of the transaction volume.

Etsy is one of the biggest beneficiaries of the pandemic, where it saw multiple years of growth pulled forward. It allowed potential sellers to explore micro-entrepreneurship and gave potential buyers more time to discover and engage e-commerce platforms like Etsy, resulting in extraordinary growth in Etsy's userbase and merchandise sales. It also helped solidify a new decentralized subset of commerce – broadly defined as the gig and passion economies, or side hustles. The last few quarters show that these tailwinds are sustainable, making Etsy a much stronger business than pre-pandemic. We believe these secular trends are likely to continue beyond the reopening.

Etsy checks many boxes of a business we want to own over five to ten years. Some attractive virtues include:

- Etsy is a pure-play online marketplace, which is a *very powerful business model*. Marketplaces benefit from an organic demand funnel fueled by economic expansion and secular trends like shifts towards digital commerce. Etsy employs a royalty-based revenue model on the volume generated through this funnel, meaning it essentially collects a toll on every transaction it helps facilitate, leading to strong organic growth.

  Other larger, more integrated marketplaces carry inventory or offer warehousing and logistics services, which tend to be lower-margin and more capital-intensive. As a pure-play online marketplace, Etsy outsources these services and retains only the most lucrative component of the model – matching buyers to sellers on the marketplace. This business is *high-margin and asset-light*. The true asset is the marketplace brand and its ability to generate royalty-like revenue off that brand. This means that Etsy can generate higher levels of growth more cheaply than some of its competitors.

- This model also creates an asymmetric relationship between revenues and expenses during inflationary times. On the revenue side, Etsy enjoys an inflation hedge when sellers raise prices to offset their rising costs. On the expense side, the sellers bear most of the inflated costs. Also, its asset-light model carries minimal reinvestment needs, meaning it does not have to pay inflated prices on capital investments.

- There is an inherent *network effect* in the online marketplace model. Each new buyer or seller added to the ecosystem makes the platform stronger and improves the value proposition to all other participants. The flywheel effect makes customer relationships stickier, leading to higher retention rates and sales per user.

- Since reinvestment needs are small, most of its high-margin profits convert to distributable free cash flow. Rather than returning capital to shareholders, management is reinvesting into high-return ventures like acquiring other niche marketplace platforms. This allows them to expand into new retail categories and geographies and target new demographics. This roll-up acquisition model is exciting because it opens up a larger addressable market and more revenue upside as Etsy applies its monetization strategy to these underearning marketplaces. This capital allocation strategy is also a great application of the value creation dynamic we look for, which combines high returns on incremental capital with a long runway of reinvestment opportunities.

We like what Etsy adds to the portfolio by providing diversified exposure to an attractive industry with a long runway for growth. The market has been punishing growth stocks lately, especially those that benefitted greatly from the pandemic. Further, since Etsy is more asset-light and has a long growth runway, it is more sensitive to the threat of rising interest rates, making share prices more volatile. Refer to our piece about How interest rates affect stocks for more details on how this dynamic works. However, if the growth is sustainable and the business is structurally stronger today (which we believe Etsy is), this presents an attractive buying opportunity for an investor with a longer-term outlook. (Matt Holman, CFA)

Autodesk (ADSK) sells mission-critical software for design, animation, manufacturing, architecture, engineering, and construction. It pioneered computer-aided design in the early 1980s with AutoCAD, and it has since expanded into complementary solutions with products like Fusion 360, Revit, Inventor, and Maya.

Most of us have benefited from Autodesk's software without realizing it. Our offices, roads, cars, cities, etc., were likely, at one point, touched by Autodesk's products. Its software works behind the scenes to improve our physical world, and we think it will do so for many decades to come.

Autodesk's greatest moat source is its switching costs. Millions of designers, engineers, and architects have built their careers on its products, and it would be too costly for them to switch to another software. Additionally, since most professionals in these jobs are proficient in the same software, new professionals entering the workforce are incentivized to learn them. In many cases, proficiency in Autodesk's software is table stakes for these professions.

Autodesk is currently undergoing a billing model transition from multi-year collections to annual collections. This will have a negative impact on near-term cash flow, but it has a minimal impact on the intrinsic value of the business in our estimation – certainly not as large of an impact as the stock price decline would suggest. Due to the stickiness of its products, we do not expect customer attrition to increase in response to this billing model change. In fact, we think the annual billing will allow for more flexible pricing strategies and greater customer satisfaction. Management has a history of executing on business model transitions, and we do not expect this time to be any different. We are happy to endure short-term cash flow dips with the prospect of increased long-term earning power, and we think this applies in the case of ADSK. (Louis Foxwell, CFA)

CoStar (CSGP) is the leading information services provider to the commercial real estate (CRE) industry. For more than 30 years, it has served brokers, landlords, property managers, investors, lenders, and appraisers as a repository of CRE data. Its leadership in data and analytics propelled its success into adjacent CRE market opportunities, such as listing services, marketplaces, and exchanges. CoStar has become ubiquitous in U.S. commercial real estate, as most transactions in the industry involve a CoStar customer.

Now that CoStar is firmly entrenched in the CRE market, it has its sights set on the residential market. This is an ambitious undertaking, but we are confident in the company's two-pronged strategy: (1) build a platform that facilitates open collaboration between home buyers and their agents, and (2) allow listing agents to maintain control of their listings on the portal. CoStar will primarily monetize this platform with subscription-based promoted listings, which is the model it uses for its commercial sites. This differs from Zillow, which sells ads to "Premiere Agents" who pay a fee to take business from the original listing agent. We think CoStar's agent-friendly model will establish customer loyalty on the platform and, in turn, produce a better experience for home buyers.

CoStar recently acquired and retooled Homes.com and Homesnap. These assets will form the basis for the residential platform. The investments in content, marketing, and software development on the platform are just beginning to ramp up. During the quarter, management announced that it would invest more than $300 million in the residential business this year. They also stated that the residential business would one day be larger than the commercial business – an astonishing assertion given the dominance of the commercial business. Why, then, did shares plummet after the announcement?

In our experience, investors become skittish when companies invest through the income statement into ventures that have a 5+ year time horizon. Earnings temporarily decline, the financial statements become convoluted, and the mere risk of the investments failing creates a highly emotional response (regardless of the precise probability of failure). We, on the other hand, view these situations as ideal for our investment temperament and approach. We are willing and able to do the extra digging and analysis, and we are, more importantly, willing to be patient.

We can look at management's track record and see that the residential investments are not a dart throw. They are calculated, just as the scaling of Apartments.com and LoopNet were, and we think the supply-side approach of attracting agents is a shrewd way to penetrate the residential market. CoStar has a history of maintaining a long-term investment horizon. It also has a history of leveraging proprietary content to lower customer acquisition costs and drive industry-leading engagement. It knows how to procure content, when to be aggressive in marketing, and how to effectively implement stratified pricing for promoted listings. If any company can scale a novel residential marketplace, we think it is CoStar. Therefore, we believe the market's reaction to the announcement of higher investment spend was irrational, and we viewed the lower stock price as an attractive opportunity to build our long-term position. (Louis Foxwell, CFA)

Meta

Meta Platforms (FB) (formerly Facebook) owns a collection of social media applications, which includes Facebook, Instagram, WhatsApp, and Messenger. The company recently intensified its focus on building augmented reality (AR) and virtual reality (VR) assets, which it assigns to a separate segment called Reality Labs.

During the quarter, management lowered revenue guidance for Q1 and cited numerous headwinds. Sentiment surrounding the stock quickly turned negative as a result. The main points of concern among investors were (1) TikTok taking share of user engagement, (2) lower-quality ad targeting and measurement due to Apple's IDFA deprecation, and (3) increased investment in Reality Labs. We will address these concerns one-by-one.

The TikTok threat has been creeping into the picture for a couple of years, but we believe the social element of Meta's properties gives them more long-term sustainability. The company has already gained excellent traction in short-form video with its Reels product. Reels will take time to monetize, but Meta has a long history of successfully monetizing new formats (e.g., Stories). Furthermore, we think TikTok is at risk of being heavily regulated or even banned due to China's involvement with the platform.

The second concern above – lower-quality ads on the platform – is the result of Apple's changes to its user tracking policy. This impacted Meta's ability to target and measure ads, which hurt its value proposition to advertisers and, in turn, led to decreased spending on its platforms. Broadly speaking, Meta has always been vulnerable to third-party control of mobile operating systems. By controlling the mobile form factor, Apple and Android get to set the rules. This limits Facebook's control of things like user tracking, payments, and data usage. We are seeing the negative effects of this today.

We think Meta will circumvent targeting and attribution issues on mobile, as it is already re-gaining efficiencies with tools like Conversions API. We are also confident that it can continue to move down the funnel to shopping and payments, which would close the ad loop and allow for more seamless data collection on its platforms.

The vulnerability to Apple's policies is precisely why we believe the third "risk" – increased investment in Reality Labs – is actually a strategic necessity. We think investment in Reality Labs is prudent because it gives Meta an avenue to own the next computing platform (AR and VR). This will allow it to control its own destiny in the core advertising business. It will also create additional revenue streams like hardware, app store fees, and software.

The company recently rebranded to better reflect its focus on Reality Labs, with the name "Meta" alluding to the Metaverse. The Metaverse is, most simplistically, a set of standards, protocols, technology, and access devices which facilitate shared virtual places and experiences. Meta wants to pioneer this new medium, and it has allocated substantial shareholder capital into building out the hardware and software that is necessary to accomplish that goal. Meta is not alone in making investments in this burgeoning space, but it has seen the most traction thus far in VR with Oculus Quest 2 reportedly selling more than 10 million devices. We think a flywheel of developer interest in the platform will soon take hold, leading to better content and more consumer interest in the product. While Zuckerberg's vision seems speculative on the surface, we think it provides a high degree of potential upside that the market is not appropriately pricing into the stock. We also share his belief that some form of the Metaverse will one day be important to our daily lives.

Meta has a long history of overcoming obstacles and emerging stronger from them. Its investments are often controversial, but they usually turn out to be the correct course of action. To prove its ability to adapt and innovate, we can look at the transition to mobile, the monetization of the News Feed through native ads, the monetization of Stories, the acquisition of Instagram, and the acquisition of Oculus. We do not think this time will be any different, and we continue to purchase shares of FB when the stock price is significantly disjointed from our estimate of the company's intrinsic value. (Louis Foxwell, CFA)

We swapped capital from **Visa (V)** into **Mastercard (MA)** for clients that did not own it or owned an underweight position. While we still like Visa, we favor Mastercard due to its more diversified exposure in foreign markets and focus on newer alternative forms of digital payment.

We discussed the underlying performance drivers last quarter in the 2021 Annual Letter, and they remain largely the same.

- First, the pandemic has been a headwind for the payments industry – specifically in cross-border transaction volume due to a lack of international travel. Cross-border commerce is Mastercard's most lucrative business since it generates much higher revenue on transaction volume and higher incremental margins due to a predominantly fixed cost structure.

- Second, the growth in fintech disruptors has some in the market questioning the long-term durability of the legacy payment rails. Specifically, bearish investors point to Buy Now Pay Later (BNPL) platforms, cryptocurrencies, and central bank digital currencies (CBDC) as alternatives that could ultimately unseat the networks with potentially cheaper or better payment solutions. We see meaningful limitations to each of these options. Each will need to rely on the networks to prove feasibility at scale. Therefore, the networks are positioning themselves as "enablers" of these disruptors rather than competitors. For example, many BNPL platforms require a linked debit card for payment, meaning the volume still ultimately flows through the legacy payment rails. Further, the installment plan splits this volume into multiple transactions. Under this structure, the networks can now charge a fixed fee on each installment payment rather than one on the total purchase.

Visa and Mastercard have delivered tepid performance dating back to the early days of the pandemic primarily due to the concerns outlined above. However, both started to outperform last quarter as the economy reopened and international commerce strengthened. The timing also coincided with the Fed's November meeting when it first expressed concerns about rising inflation and its intentions to raise interest rates. We believe this outperformance signifies a few things, including (1) the market viewing the networks as safe havens, (2) supporting our thesis that the networks function as viable hedges against inflation, and (3) the market assigning a premium for the low-duration nature of its cash flows in a rising rate environment.

This outperformance lasted until Russia invaded Ukraine in late February. The invasion revived some of the headwinds from the pandemic, namely decreased travel, reduced spending, and further supply chain disruptions. However, we continue to view these issues as transitory, with little impact on the long-term earning power of the business. Therefore, we believe this period has created a *loaded spring* and a company that could outperform in a post-COVID/post-conflict environment. (Matt Holman, CFA)

Take-Two Interactive Software (TTWO) creates and publishes interactive entertainment. Its IP portfolio includes *Grand Theft Auto (GTA)*, *NBA 2K*, *Red Dead*, *Max Payne*, *Civilization*, and *BioShock.*

In early January, Take-Two announced its intention to acquire mobile games developer Zynga in a $12.7 billion deal. The market initially reacted negatively to the announcement, with many investors questioning the rationale behind the acquisition. It was seen by some as a deviation of character for a management team that has historically allocated capital very conservatively. The acquisition price, which represented a 64% premium to Zynga's previous closing price, was viewed as an overpay for a lower-quality business. We viewed it differently, and we think this pivotal acquisition will ultimately be considered a brilliant strategic move by CEO Strauss Zelnick and the rest of Take-Two's management team.

In Zynga, Take-Two is acquiring millions of additional customers to which it can cross-sell its own IP, development technology to supplement its proprietary game engines, thousands of mobile developers with valuable domain expertise, teams of data scientists, mobile-native IP, and a robust advertising platform.

Mobile gaming is a different animal than console and PC gaming. It represents the largest and fastest-growing segment of the industry, but it is characterized by rapid player turnover and requires a finely tuned customer acquisition engine. Take-Two needed to establish scale in the space, as only ~10% of its bookings come from mobile, and acquiring Zynga was perhaps the most efficient way to do it.

We think the acquisition will enable Take-Two to lower customer acquisition costs and expand its player base. We also think Take-Two is shrewdly acquiring the company at a time when sentiment surrounding Zynga is poor. Apple's IDFA deprecation pressured Zynga to establish a closed ecosystem, but it lacked the content breadth to succeed. Take-Two offers world-class IP and a back catalog of titles that can be cross-promoted within this ecosystem. The large acquisition premium appears steep on the surface, but not when you consider that the premium was tied to an extremely depressed stock price. Further, the potential synergies will significantly lower the implied valuation multiple.

Video game development talent is scarce, and Take-Two has quietly been accumulating it over the last few years. Its labels offer developers financial upside via internal royalties, which means they pay them less upfront. This embeds substantial operational leverage into the business, which has not yet been tapped due to the long production cycles of its games. Once the next slate of games is released, we see the potential for a step function increase in both revenue and margins. The addition of Zynga's mobile assets will give its talented developers the tools and distribution needed to reach tens of millions of additional customers with these games. In our estimation, a successful transition of the *GTA* IP to mobile alone would create billions of dollars of additional equity value and make the Zynga acquisition a brilliant one. (Louis Foxwell, CFA)

VAIL RESORTS **Vail Resorts (MTN)** owns the largest and most prestigious collection of ski resorts in North America. Its properties include Vail, Beaver Creek, Whistler Blackcomb, Park City, and Breckenridge. Vail's most lucrative revenue stream is lift tickets, and most lift tickets are sold through the Epic Pass product. For the 2021/2022 ski season, Vail sold more than two million Epic Passes to customers willing to purchase tickets before the ski season began. When we initiated the position three years ago, there were fewer than one million Epic Pass holders. Pass growth has far exceeded our expectations, especially considering that the pandemic created arguably the most challenging environment in the company's history.

Advanced commitments transfer weather risk to customers in exchange for cheaper daily rates. They also increase retention and revenue visibility which de-risks investment planning. Last season, Vail lowered the price of its pass products by twenty percent, creating a surge in demand which led to labor shortages and overcrowded slopes. This concerned investors who believed the customer experience was eroding at Vail's properties as they attracted too much demand. When a company sells too much of a product or service (a good problem to have), recalibration of supply and demand takes time. How can Vail fix this issue? By investing in terrain expansion, lift upgrades, wage increases, and additional resorts for the pass network.

We do not believe customers will permanently leave the Vail network in response to one subpar season experience. Premium ski resorts in North America are scarce. Due to environmental regulations and capital requirements, it is unlikely that any more will be built. Vail owns more of them than its main competitor, Alterra, which sells the Ikon Pass. Vail charges less per visit with its pass product (more than $200 less for the full pass) and offers unlimited access to more than twice the number of destinations. At the same time, it generates more revenue. This model, which is often referred to as "scale economics shared," is difficult to emulate. By offering a better value, Vail attracts more customers, which widens the revenue gap relative to its competition. Instead of pocketing the additional cash flow, Vail reinvests it back into the customer experience. As a result, the customer value proposition "gap" widens relative to its competition over time.

We want to own this business as this gap widens with each passing year, as we believe it will translate to attractive levels of intrinsic value growth. We expect Vail to continue to grow its passholder base, gain market share, and acquire more of these scarce resorts each year. We have no interest in trading in and out of the position due to short-term fluctuations in weather and labor availability.

During the quarter, Vail purchased a majority stake in Andermatt-Sedrun – a Swiss ski resort. This is its first acquisition in Europe (the world's largest ski market), and we think it marks the beginning of the company's next growth phase. We have long expected such an investment, and we are pleased that the company is finding attractive uses for its large cash pile. (Louis Foxwell, CFA)

Sells

The positions below were reduced or eliminated in most accounts. In some cases, positions were kept in selected client accounts for tax purposes.

We continued to trim **Apple (AAPL)** positions in accounts that held overweight positions this quarter. We still view this as one of the stronger businesses in our portfolio. However, we believe its valuation remains stretched at these prices, and our investment thesis is maturing as the business grows. Sustaining growth will be challenging at its current size now that it has reached greater penetration levels across the world. Incremental growth will likely need to come from ancillary device sales (like AirPods and the Apple Watch), a more frequent upgrade cycle, and subscriptions to Apple's services portfolio. We see limitations to each of these growth drivers, specifically if elevated inflation leads to decreased real wages and consumers tighten their spending habits. Therefore, on a relative basis, Apple shares look even more overvalued than companies heavily punished in this selloff. Therefore, we saw this as a prudent source of capital to swap into some of our ideas which we think offer greater upside potential. (Matt Holman, CFA)

We also continued to trim **Berkshire Hathaway (BRK/B)** positions this quarter and redeploy the capital into some of our other ideas that we believe offer greater long-term upside potential. After several years of lagging the broader indices, Berkshire has performed well over the past few quarters as it benefitted from a rotation out of growth companies and from macro swings like rising energy prices and interest rates.

However, we still question the long-term upside potential in these more mature and highly cyclical industries. We also have concerns about the overall size of the business and its ability to make meaningful investments at scale. For example, Berkshire owns 5.6% of Apple, the largest company in the S&P 500 (roughly a $2.8 trillion market cap). To continue growing faster than the market, it will need to find other undervalued opportunities at this scale to meaningfully move the needle.

We believe this period of outperformance is more likely transient. At this stage, Berkshire acts as a portfolio diversifier and helps protect capital, but market-beating returns are unlikely to be the norm over the long term. We think there is greater long-term upside potential in other names, especially after this recent rise in Berkshire's shares and sharp declines elsewhere. (Matt Holman, CFA)

We still view **Alphabet (GOOG)** as a core holding and one of the finest businesses in our investable universe. We are pleased with its progress in Google Cloud, and we are impressed by the growth and quality of Search and YouTube. However, GOOG's outperformance last year caused the stock to become significantly overweight in some accounts. In consideration of these weightings, and the stock's valuation, we trimmed GOOG in those accounts to a level that was still overweight but within a more prudent allocation range. We reallocated the proceeds to other core positions which we felt were selling at attractive prices. (Louis Foxwell, CFA)

We think the management team at **Hilton (HLT)** navigated the pandemic well and positioned the company to thrive in a recovery. However, we thought the stock price significantly overshot the company's intrinsic value. We are usually willing to hold modestly overvalued positions, but we felt in this case that the high premium was an attractive opportunity to swap HLT into more undervalued and higher-quality companies. (Louis Foxwell, CFA)

Microsoft (MSFT) has been a very strong performer and has grown into an outsized position in many accounts. Microsoft is a diversified technology giant with business units in the cloud, software, gaming, social media, and digital advertising. There are strong secular trends in these verticals, but some are more mature than others. Further, many accounts hold other large positions with exposure to these same industries. Therefore, trimming overweight positions allows us to lock in gains while limiting exposure to a single company and limiting overall exposure to these specific secular trends. (Matt Holman, CFA)

TJX Companies (TJX) is another business we continued to trim and swap out of this quarter. When we assess companies across the portfolio, we consider the overall quality of the business, the opportunity for growth, and our level of conviction, especially as it relates to its long-term durability. For TJX, this is simply a case where the business ranks lower on our list. It is still a very good business relative to the broader market, but we prefer other names and see greater value elsewhere.

TJX will also be tested if this is a prolonged inflationary environment. Inventory and shipping costs could remain elevated, and TJX may not have the pricing power to pass on these higher costs without curtailing store traffic and average ticket sizes. Sales of more discretionary items will be pressured if real wages decline meaningfully and consumers adjust their spending habits accordingly. In short, we don't think current share prices offer enough of a margin of safety as there are more attractive opportunities elsewhere. (Matt Holman, CFA)

VERISIGN

We view **Verisign (VRSN)** as one of the more stable and predictable companies in the portfolio, and its premium valuation reflects that. Its stability comes from predictable growth in website domain registrations and contractually scheduled price increases outlined in its contract with its regulator, ICANN. For example, Verisign can increase the annual rate of .com domains by 7% in four out of every six years.

This makes Verisign more "bond-like" than other equities. This stability provides a floor during tougher economic times but also caps its upside. On one end, it acts as a ballast in the portfolio by moderating the volatility of returns. This guaranteed increase is attractive for real returns when inflation is low. On the other end, Verisign cannot increase prices above 7% when inflation runs high to offset the inflated costs, meaning its real returns could suffer.

That said, we still view Verisign as a very high-quality company. However, it is close to fully valued at current prices so this became a source of capital to redeploy into companies we believed were selling well below our estimate of their intrinsic value. (Matt Holman, CFA)

VISA

We trimmed overweight positions in **Visa (V)** this quarter and swapped capital from Visa into **Mastercard (MA)** for accounts that did not own it or held underweight positions. We still like Visa and remain attracted to its strong competitive position and sustainable growth runway. However, due to years of strong performance, some positions had grown to be very overweight. Trimming Visa also allows us to diversify our exposure to the payments industry. Please refer to the Mastercard note in the "Buys" section for more details and our thoughts on the transaction. (Matt Holman, CFA)

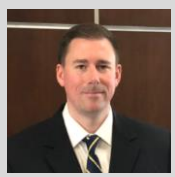
Investment Team

John Heinlein

Senior Portfolio Manager and Managing Director

Louis Foxwell, CFA

Senior Research Analyst and Assistant Portfolio Manager



Matthew Holman, CFA

Senior Research Analyst and Assistant Portfolio Manager