HORAN CAPITAL MANAGEMENT

PORTFOLIO COMMENTARY – DECEMBER 2021

Happy New Year!

I hope this letter finds you and your loved ones in good health. As I write this, the latest COVID variant, Omicron, is spreading rapidly throughout the country. It's hard to believe that we are still dealing with the pandemic after two years of lockdowns, vaccinations, testings and mask wearing. Aside from the very serious human tragedy, I know we all have grown weary of dealing with this and I am hopeful we are nearing an end soon.

Like a lot of businesses, our office in Hunt Valley, Maryland has learned to cope with the pandemic. Our staff was already set up to be able to work remotely so thankfully there were no interruptions to our workflow. Like most, we have become experts at communicating through various technologies over the past two years.

2021 was a transition year for us since it was our first year operating under the Connectus umbrella. One of the many benefits has been an upgrade to all of our technology systems that will enhance how we are able to deliver our service to you. We should be fully integrated by the first half of this year. Among the technology upgrades are a more robust CRM system and portfolio database, as well as a vastly superior trading system. These upgrades will help us deliver our services and better manage client portfolios.

To reiterate what we said before we joined Connectus, we continue to operate independently. The Connectus model was created with the idea to centralize our back office in order to do the things we do best: advise and counsel clients, and manage their investments. Along with this, we now have a variety of additional resources to tap into from our relationship with Focus Financial Partners

We recently hit an important milestone as we crossed the $1 billion of assets under management mark. This is quite an achievement from starting the firm with two people in a basement office back in 1995. It goes without saying that we could not have done this without the trust and confidence of our clients and for that we are very grateful. I'd like to take this opportunity to thank you for being a client.

I also want to mention that we have decided to refresh our company name this year. We are working with a marketing company currently and we will make an announcement soon so stay tuned for more on that.

Lastly, thanks again for your trust and confidence. We are always looking to help others so if you know anyone that needs help, please keep us in mind. We all would like to wish you a happy and healthy 2022. Cheers!

John Heinlein

Managing Director

The following discussion mentions stocks that are widely — but not universally — held by clients of Horan Capital Management. Client portfolios are customized, so this commentary may or may not be directly applicable to any given client or account. Our intention is to provide general insight into portfolio holdings and into our overall approach and to highlight situations of interest, both positive and negative. The mention of any stock is neither advice nor a solicitation to buy or sell any particular investment and our opinions regarding securities are subject to change without notice. Investing involves risk of loss. See the legal disclosures at the end of this publication and on our website for more information.

Top Contributors

Several of our core equity holdings had strong performances in 2021 and thus were the biggest contributors to overall performance.

After a few years of modest performance versus the S&P 500, **Alphabet (GOOG)** turned in a strong 2021 – it's best since 2015 – and was among the best performers in clients' portfolios this year. The market has been undervaluing Alphabet's dominance the past few years and valuing it in line with the rest of the market. However, Google and YouTube are the two most visited websites in the world. We view the Google Search platform as one of the best businesses in the world due to its high cash margins and wide economic moat. Google is the unquestioned leader in the concentrated digital advertising industry. This industry is still growing, and Google's deep-rooted user mindshare and sticky ecosystem ensure that it will capture a large portion of this growth.

While Google Search is Alphabet's crown jewel business, Google Cloud and YouTube have been accelerating overall growth and causing the market to re-rate the stock. The mass migration of businesses moving to the cloud is a common thematic trend you will see in our core holdings, and the pandemic hastened the

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urgency to act. YouTube's growth shows that there is a strong appetite for video-based content and thus an opportunity for advertising revenue. We expect the Search business to continue to deliver modest growth and substantial cash flow – allowing management to reallocate capital to growth divisions like cloud, YouTube, and its Other Bets ventures.

Microsoft (MSFT) has been experiencing a "growth renaissance" over the past few years. It helps businesses shift operations to cloud-based infrastructures, resulting in astounding growth in its Azure division. Further, Microsoft repackaged some of its top flagship products (Windows OS, Office, and Dynamics) and moved them to the cloud instead of the traditionally licensed on-premise versions. The new subscription-based pricing model has stimulated revenue growth and helped boost operating margins due to increased operating leverage. The pandemic has functioned as an accelerator for digital adoption curves and helped pull forward growth in many other segments. With more employees working remotely, the need for integrated operating systems and workflows is at an all-time high. Moreover, the pandemic boosted engagement levels in its gaming, LinkedIn, and advertising divisions, allowing Microsoft to monetize the burgeoning customer needs stemming from the effects of the pandemic.

Apple (APPL) was a strong performer in both 2019 and 2020, and shares outperformed again in 2021 – albeit more modestly. The iPhone 12 release came with a great deal of pent-up demand because it was the most incrementally superior model in a few years. Initial sales were strong, but the pandemic helped extend the sales cycle well into 2021. The iPhone SE model also helped Apple capture a new demographic by offering a quality new product at a lower price point. Apple also noted an uptick in first-time buyers, upgraders, and multi-product users.

Apple is still a high-quality business and cash-generative machine. Management has been allocating capital to grow the breadth and quality of its services business while diligently returning capital to shareholders via share repurchases. The higher mix of services revenues has helped reaccelerate growth and improve profitability via higher incremental margins. The combination of multi-device users and increased usage of the services platform helps fortify Apple's economic moat while further engraining its ecosystem into the lives of its users. Accordingly, the market has re-rated the stock as a services company with a higher multiple.

S&P Global (SPGI) fired on all cylinders in 2021. The Ratings segment thrived on the elevated issuance of structured products and bank loans, as well as a healthy non-transactional business (e.g., credit surveillance). The Indices business benefitted from the strong performance of domestic equities, which translated to higher asset-linked fees. Platts was a key beneficiary of the recovery in energy markets, and Market Intelligence saw greater demand for its data assets and desktop solutions in the face of a complex and uncertain market environment.

We will closely monitor the prospective merger with IHS Markit. Both companies have agreed to divest assets to get the deal through regulatory approval, but the core assets remain in place. We think the combined entity will create enormous value for shareholders, and we expect the deal to close in the first quarter.

Domino's Pizza (DPZ) has been a notable beneficiary of the pandemic as well. Consumers have become more reliant on delivery channels for food, and the QSR pizza market has thrived as a result. Domino's has done an exceptional job of driving value for customers and franchisees in this environment, and the benefits are accruing to us as shareholders. The dense delivery network that Domino's franchisees leverage, as well as the scale benefits across the supply chain, are leading to great prices and convenient meals for customers.

Domino's has clearly benefited from the circumstantial changes in consumer behavior, and we think much of the associated increase in demand will stick in the long term. As we emerge from the pandemic, we will be monitoring international expansion efforts, delivery market share, and the growth of high margin carry out revenue. We expect Domino's to continue sharing scale economics with consumers and franchisees, primarily through the delivery business, which we think will lead to long-term value creation for shareholders.

Top Detractors

Some of our core holdings had challenging years in 2021. We constantly re-assess our investment thesis for potential impairment. If headwinds are more likely transitory, the suppressed price can often create opportunities for long-term returns. Therefore, the performance detractor list often coincides with our portfolio additions and new purchases list – in cases where prices fall below our estimate of intrinsic value.

The payment networks – **Visa (V)** and **Mastercard (MA) –** were among the biggest detractors to overall performance in 2021. The pandemic has significantly impacted international travel and commerce, which cuts into the credit networks' cross-border

payment volume. The networks charge much higher fees (typically 6-8 times higher) for cross-border transactions than domestic volume. Since the associated costs are primarily fixed, this revenue generates high incremental profit margins, making it the networks' most lucrative business.

The networks also face a host of new competitive threats from potentially disruptive payment options. First, Buy Now Pay Later (BNPL) payment platforms have seen significant growth among millennials and have dominated headlines this past year. Second, cryptocurrency-based payment options offer a decentralized processing alternative that also resonates with the younger generation. Lastly, central banks are developing digital currency payment systems (CBDC) to retain control over their sovereign financial infrastructure as new options emerge.

These alternative payment rails fail to offer a superior option to a process that is not broken. Visa and Mastercard's payment networks are efficient, reliable, and well established in consumer wallets and merchants' settlement processes. Each potential threat has its flaws – whether they are inherently more costly to merchants and risky for consumers (BNPL), too volatile and subject to regulation (cryptocurrencies), or unproven (CBDC). Re-training consumer behavior to adopt these alternative methods is also difficult, and it would likely take years to overcome the inherent switching costs.

The video game publishing industry, notably **Activision Blizzard (ATVI)** and **Take-Two Interactive (TTWO)** saw increased engagement levels with people sheltering at home during the pandemic. However, they have seen those levels plateau lately and have met some new challenges in 2021. Supply chain issues have delayed the availability of the latest consoles, which has given gamers a reason to wait on buying this year's games. China placed restrictions on its younger population, hurting the publishers' ability to monetize the games in a growing market. Both major publishers have announced delays of new titles this year, which led to modest selloffs in the share prices. Also, until the consoles reach critical mass levels among their gamers, there is not much urgency on the demand side.

Activision encountered its own issues in the past few quarters, which we are monitoring closely. Regulators are investigating the Blizzard division's workplace culture, which has led to some condemnatory allegations. This has created volatility in the stock price; however, we are hesitant to react hastily to the news until we have more clarity. Video game publishing is such a high-quality business model with powerful secular tailwinds, and shares could be attractively valued here. Therefore, we are willing to be patient while the short-term headwinds subside, and more information comes to light, before determining whether this changes our investment thesis.

Fair Isaac Corporation (FICO) faced its fair share of negative headlines throughout the year – the most common of which was the threat of more competition. Investors became concerned about fast-growing fintechs like Upstart, as well as incumbents like VantageScore. The market also appears to be in waiting mode as the Federal Housing Financing Agency (FHFA) reviews additional credit scoring models for mortgages. Lastly, investors have become impatient with FICO's internal reinvestments into its decision management platform.

In our view, investors commonly mischaracterize FICO's value proposition which, in turn, leads to a misidentification of competitive threats. The FICO Score offers a *standardized* measurement of a consumer's propensity to repay debt. It acts as a common language for stakeholders – banks, investors, regulators, and consumers – which creates a more efficient ecosystem and ultimately lowers the cost of debt for consumers. As a common language, the scoring methodology must be broad enough to allow these constituents to seamlessly interact in the face of disparate datasets and regulations. It is a cost-effective benchmark, screening tool, and foundation for additional analysis by customers.

Companies like Upstart, which use alternative data and AI to determine the creditworthiness of consumers, are adding value to pockets of the market; however, we do not believe that their products can become a standard like the FICO Score. In fact, most of these companies are customers of FICO and FICO encourages them to build off the score with their novel approaches. Banks have been doing this internally for years, and their success has translated to success for FICO.

As it stands today, the FHFA requires banks to use FICO Scores for all mortgages delivered to GSEs like Fannie Mae and Freddie Mac. This has led to FICO establishing a monopoly in mortgages and securitized consumer loans. The FHFA has been reviewing new credit scoring models for mortgages since 2020, and investors are concerned that the FICO Score will lose its monopoly if a competitor like VantageScore is approved. The FHFA will likely announce its decision in 2022. We think the market has been pricing the stock as if an additional score will be approved *and* will take significant share of the market. While an additional score may be approved, we think FICO will retain most of its market

share and pricing power as the switching costs are too high for banks.

FICO's investments in its software business, and specifically its decision management platform, have drawn scrutiny from investors. Management recently provided new disclosures regarding the platform, and we think early results are promising. In our opinion, this venture offers attractive optionality to shareholders and is an intuitive destination for equity capital given the company's expertise in analytics. We believe it will take a few years to play out, and we are willing to take the long view.

Another underperformer during the year was **CoStar Group (CSGP)**, which faced challenges in its Multifamily segment. Occupancy rates at apartment communities were significantly higher than historical averages during the year, which prompted property managers to pare back advertising spend at Apartments.com. We think current occupancy levels are unsustainable for two reasons: (1) renters appear to be in waiting mode because of the pandemic, and (2) automated yield management systems will continue to increase rents until occupancy rates fall back to historical levels. Thus, we expect a surge in demand for premium ads at Apartments.com when the rental market "resets." Management's rationalization of ad tier pricing should provide an additional surge to the business in conjunction with this reset. Overall, we are excited about the long-term prospects of the Multifamily business.

CoStar's other assets continue to perform well, and we are encouraged by management's strategy to acquire a greater share of the residential market. This market offers a very long reinvestment runway (as does the commercial market). CoStar has an exceptional M&A track record, giving us faith that the reinvestment will bear fruit for shareholders.

The pandemic-related headwinds that **Booking Holdings (BKNG)** faced in 2020 carried into 2021, as travel demand in Europe has yet to return to pre-pandemic levels. However, Booking's variable cost structure has allowed it to withstand nearly two years of historically poor industry conditions, and its balance sheet has remained strong as a result. The company took advantage of this during this year by making multiple strategic acquisitions.

In our opinion, Booking will emerge from the pandemic in a stronger competitive position. Though the timing of recovery remains uncertain, we think the European travel industry will flourish again and independent hotels will be reliant on Booking for customer acquisition. We are also confident that Booking will be a major player in the alternative accommodations business, allowing it to benefit from behavioral changes that have occurred during the pandemic.

Investment Team

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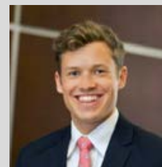
Senior Portfolio Manager and Managing Director



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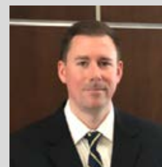

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